No. 90-

IN THE
Supreme Court of the United States
OCTOBER TERM, 1990

THOMAS AND SHARON FREYTAG, JOE AND GLADYS WOMBLE, BERT AND MILDRED TIMM, KENNETH AND CANDACE McCOIN,

Petitioners,

v.

COMMISSIONER OF INTERNAL REVENUE,

Respondent.

PETITION FOR WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FIFTH CIRCUIT

PETITION FOR WRIT OF CERTIORARI

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QUESTIONS PRESENTED

1. Are complex tax cases affecting thousands of parties and billions of dollars among the "other proceeding[s]" that 26 U.S.C. § 7443A(b)(4) allows the United States Tax Court to assign to a special trial judge for trial and effective resolution?

2. Does the Appointments Clause of Art. II, § 2, which allows Congress to confer power to appoint inferior officers on the "Courts of Law" and the "Heads of Departments," permit Congress to grant the chief judge of the Tax Court power to appoint special trial judges?

TABLE OF CONTENTS

TABLE OF AUTHORITIES

Cases:

Constitutional Provisions:

Statutes:

Regulations:

Rules:

OPINIONS BELOW

The opinion of the United States Court of Appeals for the Fifth Circuit is reported at 904 F.2d 1011 and reprinted as Appendix A. The opinion of the United States Tax Court is reported at 89 T.C. 849 and reprinted as Appendix B.

JURISDICTION

The decision of the Court of Appeals was entered on July 6, 1990. A timely petition for rehearing was denied on August 15, 1990. *See* Appendix D. The jurisdiction of this Court is invoked under 28 U.S.C. § 1254(1).

CONSTITUTIONAL PROVISIONS, STATUTE AND RULE INVOLVED

The pertinent portions of Art. I, § 8, Art. II, § 2, and Art. III, §§ 1-2 are set forth in Appendix E. The text of 26 U.S.C. § 7443A is set forth in Appendix F. Tax Court Rule 183 is set forth in the Appendix at A91-92.[1]

STATEMENT OF THE CASE

At issue in this case is whether a complex tax deficiency matter involving three thousand taxpayers and approximately $1.5 billion in alleged tax deficiencies may be tried and effec-

[1] Citations to the appendix bound with this petition will be styled "A ."

tively decided by a "special trial judge" appointed by the Tax Court, rather than by a duly-appointed judge of the Tax Court itself. The Tax Court is an Article I court consisting of 19 judges appointed by the President with the advice and consent of the Senate to 15-year terms. *See* 26 U.S.C. §§ 7443(a),(b) and (e); (A73). Special trial judges, who currently preside over 42% of the Tax Court's docket,[2] are appointed by the chief judge of the Tax Court for indefinite terms, under the authority of 26 U.S.C. § 7443A(a). (A100). Petitioners are taxpayers whose deficiency cases were effectively decided by a special trial judge rather than a duly-appointed Tax Court judge.

Petitioners' cases are among the three thousand taxpayer petitions pending in the Tax Court that raise the issue whether losses incurred on certain forward contracts with First Western Government Securities, Inc. ("First Western") may be claimed as deductions. (A2, A14).[3] These cases were assigned to Tax Court Judge Richard C. Wilbur, who established a "test case" procedure; ten cases (including petitioners') were selected for consolidated discovery, trial, briefing and decision. (A5, A15).[4] Trial commenced in late November 1984 but lasted only three weeks before Judge Wilbur fell ill.

The chief judge of the Tax Court directed Special Trial Judge Carleton Powell to begin presiding over the trial in December 1985, but his duties were limited to being an evidentiary referee; the proceedings were videotaped so that Judge

[2] Out of the 54,428 cases pending in the Tax Court on February 28, 1990, special trial judges had been assigned 8,781 small tax cases pursuant to 26 U.S.C. §§ 7443A(b)(2) & (3) and 14,500 complex so-called tax shelter cases pursuant to § 7443A(b)(4). (A73).

[3] Petitioners invoked the jurisdiction of the Tax Court pursuant to 26 U.S.C. § 6213.

[4] This case involves four of the test cases. Appeals from several of the other cases were taken to the Courts of Appeals for the Fourth and Sixth Circuits, see *Lewis* v. *Commissioner*, Fourth Cir. No. 89-2720; *Ames* v. *Commissioner*, Sixth Cir. No. 89-1695, but are now being settled.

Wilbur could view the evidence at home and prepare his findings and opinion upon recovery. (A5-6). In April 1986, Judge Wilbur's illness forced him to retire from the Tax Court. (A6, A72). In July 1986, the chief judge notified the parties that he would assign their cases to Special Trial Judge Powell for preparation of findings and an opinion to be submitted to Judge Wilbur, unless anyone objected to this assignment. (A6). Petitioners consented to this reassignment only on the express condition that the special trial judge's report be reviewed (and the case ultimately decided) by Judge Wilbur or by Chief Judge Sterrett himself. (A6).[5]

Special Trial Judge Powell issued detailed findings and an opinion on October 21, 1987, disallowing all of petitioners' investment loss deductions. A few hours later, Chief Judge Sterrett — who had heard none of the 16 weeks of complex financial testimony spanning three years of trial, nor reviewed the 9,000 pages of transcript and the 3,000 exhibits — adopted the special trial judge's report verbatim and entered it as the Tax Court's decision. (A6, A7).

Petitioners appealed the Tax Court decision to the Court of Appeals for the Fifth Circuit, arguing, *inter alia*, that the decision was invalid because the governing statute, 26 U.S.C. § 7443A, did not allow the Tax Court to assign this complex tax case to a special trial judge. The court below held that since this issue was "in essence, an attack upon the subject matter jurisdiction of the special trial judge, it may be raised for the first time on appeal." (A7). The court then brushed aside petitioners' arguments about the meaning of § 7443A(b)(4), holding that a special trial judge may lawfully be assigned not only minor tax cases but also "any other proceeding which the chief judge may designate," 26 U.S.C. § 7443A(b)(4), so

[5] One taxpayer objected to the reassignment altogether and that case was severed and is not at issue here.

long as the ultimate opinion is formally "issued by the Tax Court in the name of" a regular Tax Court judge. (A7).

Petitioners also argued that Special Trial Judge Powell had been appointed in violation of the Constitution by the chief judge of the Tax Court, who is neither a "Head[ ] of Department[ ]" nor a member of a "Court[ ] of Law" as required by the Appointments Clause, Art. II, § 2. The court below declined to reach the merits of this argument, holding that, "[b]y consenting to the assignment of their case at the time it was made, the Taxpayers waived this objection." (A8 n.9).

These same arguments were raised in the Tax Court in the related case of *Samuels, Kramer & Company* when the Tax Court likewise assigned that case to Special Trial Judge Powell. (A72-73).[6] Samuels, Kramer was the investment advisor for First Western, the firm with which the petitioners had their investment accounts. (A72). On April 9, 1990, the Tax Court held that it could constitutionally appoint special trial judges because it was a "Court[ ] of Law" within the meaning of the Appointments Clause. (A83-86). Aware of the significance of this controversial ruling, the Tax Court certified its order for interlocutory appeal (A89, 96) and the Court of Appeals for the Second Circuit granted Samuels' motion for leave to appeal.

Oral argument was held on October 24, 1990 and the case is now under submission before the Second Circuit. *Samuels, Kramer & Co.* v. *Commissioner*, Nos. 90-4060/90-4064. The Commissioner was represented by the Solicitor General of the United States, who argued that the chief judge of the Tax Court constitutionally wields appointment power as the "Head" an Executive "Department," but that the Tax Court certainly cannot be deemed a "Court of Law" within the meaning of the Appointments Clause. The opposing position of the Tax

[6] In the Tax Court the case was captioned *First Western Government Securities, Inc., et al.* v. *Commissioner*, 94 T.C. 32 (1990). This opinion is reprinted as Appendix C.

Court itself, that it is not an Executive Department but a "Court of Law," was presented by former Solicitor General Erwin Griswold, appearing as *amicus curiae*.[7]

REASONS FOR GRANTING THE WRIT

Petitioners argue *first*, that whatever the authority of a special trial judge to make narrow declaratory judgment rulings or to decide small tax claims, Congress never authorized such judges to function, as did the special trial judge here, in effect as full-blown surrogates for the Tax Court judges themselves. *See* Part I *infra*. *Second*, petitioners argue that, even if the governing statute does not bar the assignment and decision below, the Constitution does. For in order for the Tax Court to appoint "inferior Officers" such as special trial judges, it would have to be either a "Court[ ] of Law" or an Executive "Department" within the meaning of the Appointments Clause of the Constitution, Art. II, § 2, cl.2. But the Tax Court, which is an Article I or legislative court, is neither a "Department" nor a "Court of Law." *See* Part II *infra*.

This Court should grant certiorari to resolve these two questions for several reasons. *First*, these questions have great importance for the operation of the Tax Court. Special trial judges currently handle fully 42% of the Tax Court's docket. They handle not merely small tax claims, but also thousands of complex so-called "tax shelter" cases — at present over 14,500 such cases involving billions of dollars, constituting 26% of the Tax Court's total docket. This is so because in 1984, Congress amended 26 U.S.C. § 7443A by adding subsection (b)(4), which allows the Tax Court to assign a special

[7] Erwin Griswold, acting at the behest of the Tax Court, initially requested leave to appear as *amicus curiae* for the Tax Court judges themselves. However, the Office of the Solicitor General declined to consent to such formal separate representation for those federal officers, and thus Mr. Griswold appeared on his own behalf as *amicus curiae*.

trial judge to conduct and issue findings not only in small tax claims and other minor matters, but also in "any other proceeding which the chief judge may designate." (A100). Ever since then, the 14 special trial judges have assumed an ever-increasing share of the Tax Court's regular caseload — regardless of size, complexity or amount in controversy. This expansion of the special trial judges' authority constitutes an end-run around both the governing statute and the Appointments Clause.

The *second* reason to grant the writ is to resolve a fundamental constitutional question of grave importance to the structure of the federal government and to all who take their cases to the Tax Court: namely, whether the special trial judges who preside over nearly half the Tax Court's docket are officers appointed in violation of the Appointments Clause. So vexing is this constitutional issue that, while litigating this case and the related *Samuels, Kramer* case, the federal government has staked out a bewildering variety of positions on the constitutional status of the Tax Court under the Appointments Clause.

The government first contended before the Tax Court and the Fifth Circuit below that the Tax Court could be a "Court[ ] of Law" *or* an Executive "Department."[8] However, the Tax Division then confessed error, admitting that this constitutional analysis is "in tension" with the President's position that Article I tribunals such as the Tax Court may not wield appointment power under Art. II, § 2. (A102). *See also* A103.[9]

[8] *See* Commissioner's Objection to Petitioner's Motion for the Assignment of this Case to a Presidentially Appointed Tax Court Judge in *Samuels, Kramer & Co.* v. *Commissioner*, Tax Court No. 33758-84 at 15, 22; Brief for the Appellee Commissioner in *Freytag* v. *Commissioner*, Fifth Cir. No. 89-4436 at 48, 51 ("Govt.Br. in *Freytag*").

[9] As the government explained in a letter to the Fourth Circuit in a related case, the government's view on the constitutional status of the Tax Court "is not fully in accord with the view of the Government." *See* Letter from Shirley Peterson to Clerk of the Court for the Fourth Circuit, dated August 28, 1990. (Appendix H, A104).

Meanwhile, the Tax Court in *Samuels, Kramer* declined to be characterized as an Executive "Department" and held itself to be a "Court of Law" under the Appointments Clause. (A83-86).[10] Most recently, the Solicitor General argued to the Second Circuit in *Samuels, Kramer* that the Tax Court is definitely not a "Court of Law" but rather a "Department" within the Executive Branch. Solicitor General's Brief in *Samuels, Kramer & Co.* v. *Commissioner*, Second Cir. Nos. 90-4060, 90-4064 at 34. ("SG Br. in *Samuels, Kramer*").

Since the government cannot even make up its own mind on this constitutional question, this Appointments Clause issue should be settled by this Court. The constitutional issue was fully briefed and argued by the parties in the court below. But that court egregiously mistook this nonwaivable structural constitutional objection for a waivable personal right. This Court has not hesitated in other cases to reach and resolve thorny structural issues even where, unlike here, those issues were not even raised by the parties in the courts below. *See infra*, Part II E.

Petitioners are fully aware that there may well be mounting docket pressure at the Tax Court. But if the Tax Court requires additional manpower, the ready solution is for Congress openly to expand the number of presidentially appointed Tax Court judges (just as Congress periodically does with U.S. District Court judges) — *not* for the Tax Court to clone itself behind the scenes, with neither the careful scrutiny nor the public accountability that accompany appointment by the President. Alternatively, Congress could provide for the appointment of special trial judges in accord with the Appointments Clause,

[10] Although Mr. Griswold did not formally represent the Tax Court judges in opposing the Solicitor General in the Second Circuit, *see* note 7 *supra*, Mr. Griswold did present the position of the Tax Court and the government split its oral argument time between Solicitor General Starr and Mr. Griswold.

as it does with the magistrates and bankruptcy judges who are adjuncts to the Article III judiciary.

Certiorari should therefore be granted. At a minimum, this case should be held pending final resolution of the related *Samuels, Kramer* litigation in the Second Circuit and in this Court. That course would have two benefits: it would allow this Court to postpone consideration of the scope and constitutionality of § 7443A until a lower court gives thorough consideration to the merits of those questions, and it would avert the unfairness of possible inconsistent treatment of taxpayers in the Second and Fifth Circuits should the Second Circuit resolve these issues favorably to taxpayers while the Fifth Circuit plainly erred in deeming them waived.

I. THE DECISION BELOW DRASTICALLY EXPANDS THE JURISDICTION OF TAX COURT SPECIAL TRIAL JUDGES BEYOND THE SCOPE OF CONGRESSIONAL AUTHORIZATION.

The Tax Court and the court below have read 26 U.S.C. §7443A(b)(4) to allow the Tax Court to assign *any* proceeding to a special trial judge. This reading permits special trial judges to handle thousands of complex major tax cases — amounting to about 26% of the Tax Court's caseload and involving billions of dollars of alleged tax deficiencies. Whether Congress ever authorized this expansion therefore merits the plenary attention of this Court.

The Tax Court and the Fifth Circuit have misinterpreted § 7443A(b)(4) by reading it in isolation from adjoining provisions rather than in context. Section 7443A(b) empowers the chief judge of the Tax Court to assign certain narrow categories of minor tax cases to special trial judges for decision. Under § 7443A(b)(1), special trial judges may preside over and make the decision in declaratory judgment proceedings (involving

retirement plans, for example [11]) where the record has typically already been fully developed in the administrative process and hence the special trial judge will not conduct a full trial, resolve disputed factual issues, or tangle with a wealth of legal issues.[12] Special trial judges may also be assigned to decide small tax cases involving less than $10,000, § 7443A(b)(2) & (3), where very informal procedures are followed, legal issues are de-emphasized, evidentiary rules are relaxed,[13] and the special trial judge's decision will have absolutely no precedential value.[14] Thus § 7443A(b)'s enumeration limits the jurisdiction of special trial judges to cases in which the amount in controversy, the nature of the issues and the scope of the trial are insignificant and the potential precedential impact is nonexistent. *See, e.g., Page* v. *Commissioner*, 86 T.C. 1, 12-13 (1986).

Section 7443A(b)(4), added in 1984,[15] allows the Tax Court to assign "any other proceeding which the chief judge may designate" to be heard by a special trial judge, but that judge may not "make the decision of the court" in such a case. § 7443A(c). If taken literally, this expansive language would make the specific grants of authority in (b)(1), (2) and (3) superfluous — a result barred by elementary principles of statutory construction. *See Penn. Dept. of Public Welfare* v. *Davenport*, 110 S.Ct. 2126, 2133 (1990); *Mackey* v. *Lanier Collection Agency*, 108 S.Ct. 2182, 2189 (1988). The limits on the authority of special trial judges carefully delineated in §§ 7443A(b)(1) through (3) become meaningless if "any other proceeding" in (b)(4) is construed to permit a special trial judge to adjudicate

[11] *See* 26 U.S.C. § 7476.

[12] *See* M.Garbis, P.Junghans, S.Struntz, *Federal Tax Litigation: Civil Practice & Procedure* ¶21.02[1] (1985).

[13] *See id.* at ¶14.01.

[14] *See* 26 U.S.C. § 7463(b).

[15] *See* Deficit Reduction Act of 1984, Pub.L. No.98-369, § 463(a), 1984 U.S. Code Cong. & Admin. News (98 Stat.) 824.

and effectively decide cases such as the present "test" cases, involving billions of dollars, thousands of parties, complex facts and unsettled tax issues — subject only to a Tax Court judge's formal entry of that decision.

In *Gomez* v. *United States*, 109 S.Ct. 2237 (1989), this Court considered an expansive "catch-all" provision in the Federal Magistrates Act, 28 U.S.C. § 631, that is similar to the "any other proceeding" provision of § 7443A. Despite the broad language of the Magistrates Act, which permits magistrates to be assigned "such additional duties as are not inconsistent with the Constitution and laws of the United States," 28 U.S.C. § 636(b)(3), this Court unanimously held that magistrates could not conduct felony trial jury selection, because the catch-all provision had to be read in light of the earlier, specific grants of power. "Any additional duties performed pursuant to a general authorization in the statute reasonably should bear some relation to the specified duties." 109 S.Ct. at 2241. Therefore, "the carefully defined grant of authority to conduct trials of civil matters or in minor criminal cases should be construed as an implicit withholding of the authority to preside at a felony trial." *Id.* at 2245.

Here, as in *Gomez*, § 7443A(b)(1)-(3)'s narrow grant of power to special trial judges over declaratory judgment proceedings and minor tax cases limits the scope of (b)(4). It requires that (b)(4)'s statement that special trial judges may be assigned "any other proceeding" be construed to apply only to proceedings "reasonably . . . bear[ing] some relation" to those minor cases, *Gomez*, 109 S.Ct. at 2241, and not to complex, major tax cases such as this one. Congress deemed the addition of (b)(4) to be a "technical change," [16] and therefore it surely did not "contemplate inclusion," *Gomez*, 109 S.Ct.

[16] *See Joint Comm. on Taxation*, 98th Cong., 2d Sess., *General Explanation of the Revenue Provisions of the Deficit Reduction Act of 1984* 760 (Joint Comm. Print).

at 2245, of major tax litigation among the other proceedings that a special trial judge may be assigned.

The court below ignored the canons of statutory interpretation reaffirmed in *Gomez* and held that a special trial judge could indeed be given power over any proceeding so long as the ultimate formal opinion "was issued by the Tax Court in the name of" a regular Tax Court judge. (A7). This resolution is wholly inadequate. *First*, it ignores the fact that a proper reading of the "any other proceeding" language of § 7443A does not even authorize a special trial judge to preside over a case such as this one, let alone *decide* it.

Second, under Tax Court practice, special trial judges routinely *make* the decision of the court, even if a full Tax Court judge formally enters it in the record. Special trial judges conduct trials and prepare findings of fact and conclusions of law. Tax Court Rule 183(b). (A91). Tax Court Rule 183(c) mandates that such factual findings "*shall be presumed to be correct*" by the Tax Court judge. (A92) (emphasis added); *see Stone* v. *Commissioner*, 865 F.2d 342, 345 (D.C.Cir. 1989). This presumption flatly precludes *de novo* review by the Tax Court. And the only circuit court decision addressing this precise issue has held that special trial judge factual findings are reviewable, at most, under a "clearly erroneous" standard. *Stone* v. *Commissioner*, 865 F.2d at 344-47.

This case is a perfect example of how special trial judges routinely do the Tax Court's work with only the most cursory supervision. Findings of fact often conclusively decide tax litigation, as they did in this case, because whether a particular transaction and the deduction claimed for it will be disallowed as "a sham is," as the court below held, "a question of fact reviewed under the clearly erroneous standard." (A8). Thus Special Trial Judge Powell's conclusion that petitioners' deductions were "shams" and that back taxes were therefore owed was virtually binding on the Tax Court. That conclusion was reached

after a trial that took place over three years, involved 16 weeks of complex expert and financial testimony, generated 9,000 pages of transcript and 3,000 exhibits. Yet the Tax Court's chief judge rubber-stamped the special trial judge's findings and opinion just a few hours after receiving them without reviewing the evidence or changing a single word, thereby deciding test cases that may determine the fate of over 3,000 other tax cases involving billions of dollars.[17]

The court below virtually conceded that the Tax Court review in this case was but a rubber stamp, noting explicitly the "short time span" (A8) — a few brief hours — in which the supposed review of the 9,000 page transcript and 3,000 exhibits was accomplished. For the court below to treat this as meaningful review is truly an arid exercise in empty formalism. Although allowing special trial judges to resolve minor tax matters may comport with the congressional design, the assignment of this complex and far-reaching case to a special trial judge for effectively final resolution is inconsistent with the narrow grant of authority in § 7443A. Because this issue affects thousands of complex major tax cases handled by special trial judges — amounting to about 26% of the Tax Court's caseload — it merits the plenary attention of this Court.

[17] This legally mandated deference to the special trial judge was particularly inappropriate in this case because the special trial judge was absent from significant portions of this trial. Since he was assigned this case only after Tax Court Judge Wilbur became ill, Special Trial Judge Powell did not hear the first four weeks of trial, which included expert testimony on the fundamental nature of the underlying transactions as well as the testimony of petitioners, their financial advisors, the president of the investment company, its operations managers, its accountants, and its director of computer operations. Under Tax Court Rule 183(c), findings are "presumed to be correct" on the assumption that the special trial judge "had the opportunity to evaluate the credibility of witnesses." (A92). But here Judge Powell's findings were presumed correct even though he never heard or saw much of the most important testimony.

II. THE DECISION BELOW PERMITS THE APPOINTMENT OF SPECIAL TRIAL JUDGES BY THE CHIEF JUDGE OF THE TAX COURT, IN VIOLATION OF THE APPOINTMENTS CLAUSE.

If § 7443A(b)(4) is read, as it was below, to permit a special trial judge to preside over the trial of *any* Tax Court case, then there is no way of avoiding the question whether the Article I Tax Court is, within the meaning of the Appointments Clause, a "Court[ ] of Law" or whether its chief judge is a "Head[ ] of Department" in which Congress may constitutionally repose appointment power.

This issue is a narrow one; petitioners do not challenge the constitutionality of Article I or so-called "legislative courts." *Contrast CFTC* v. *Schor*, 478 U.S. 833 (1986); *Northern Pipeline Construction Co.* v. *Marathon Pipe Line Co.*, 458 U.S. 50 (1982) ("*Marathon*"). The question presented is not whether such tribunals may exercise some federal judicial or adjudicatory power in accord with Article III of the Constitution, but whether they may exercise appointment power in accord with Article II, § 2. Petitioners do not challenge the Tax Court's jurisdiction to conduct and decide tax cases, only its power to appoint inferior officers to perform those functions for it. The power to adjudicate issues of federal law is distinct from the power to appoint federal officers, and the appointment power does not automatically follow the power to adjudicate. Perhaps adjudicative power may be dispersed throughout the federal government without running afoul of Article III, but the power to appoint is narrowly limited by Article II, § 2.

A. A Special Trial Judge Is An "Inferior Officer" Whose Appointment Must Conform To The Appointments Clause.

The Appointments Clause, Article II, § 2 of the Constitution, governs the appointment of "all persons who can be said to hold an office under the government." *Buckley* v. *Valeo*, 424 U.S. 1, 125 (1976). As the United States Tax Court held in the related *Samuels, Kramer* case, its own special trial judges are indeed inferior officers of the United States, not mere employees. (A79-80). That holding cannot plausibly be contested.

A special trial judge plainly fits this Court's contemporary definition of an "officer" for Appointments Clause purposes, namely, an "appointee exercising significant authority pursuant to the laws of the United States," *Buckley*, 424 U.S. at 126.[18] He may rule on all pretrial and trial motions without any review by the Tax Court. Tax Court Rule 181. He may compel the production of evidence, swear witnesses, issue subpoenas and "exercise such further and incidental authority . . . as may be necessary for the conduct of trials or other proceedings." *Id.* As interpreted below (A7) and by the Tax Court itself (A76-78), 26 U.S.C. § 7443A allows a special trial judge to preside over *any* Tax Court case, to formally enter the decision in many minor tax matters, and to issue findings and opinions that may be adopted verbatim by the Tax Court without meaningful review even in the most complex and significant cases, as they

[18] Holding a Tax Court special trial judge to be an "inferior Officer" also comports with the venerable definition of "officer" formulated by Chief Justice Marshall for purposes of construing the Appointments Clause in *United States* v. *Maurice*, 26 Fed.Cas. 1211, 1214 (No.15,747) (1823): an officer is one who performs duties that are continuing and that are defined by laws or rules prescribed by government rather than by contract. *See also Burnap* v. *United States*, 252 U.S. 512, 517-20 (1920). The office of special trial judge is created by statute and the duties of the office are spelled out in statute and Tax Court rules. See 26 U.S.C. § 7443A (A100); Tax Court Rules 180-83.

were here. *See supra* Part I. As demonstrated above, the special trial judges do a substantial portion of the Tax Court's work and exercise virtually the same powers as presidentially-appointed Tax Court judges. Accordingly, they are "Officers."[19]

B. The Tax Court Is Not A "Court Of Law" Within The Meaning Of The Appointments Clause.

The power to appoint inferior officers may be reposed by Congress in the President with the advice and consent of the Senate, "in the President alone, in the Courts of Law, or in the Heads of Departments." Art. II, § 2. (A99). The fact that the Tax Court may be a legitimate Article I court does not *ipso facto* make it a "Court of Law" within the meaning of the Appointments Clause. That clause must be read in the context of the entire Constitution. As the Solicitor General of the United States formally conceded in the related *Samuels, Kramer* case, an Article I court cannot be a "Court of Law" for Appointments Clause purposes, because "the Framers used the term '*the* Courts of Law' in the Clause to refer to those courts created and existing under Article III as part of the Judicial Branch." (SG Br. in *Samuels, Kramer* at 42 (emphasis by the government).)[20]

[19] Special trial judges in the Tax Court are at least at the same level as federal magistrates in the Article III district courts, who are deemed inferior officers whose appointment (by the Article III judiciary) must comport with the Appointments Clause. *Pacemaker Diagnostic Clinic* v. *Instromedix*, 725 F.2d 537, 545 (9th Cir.) (en banc), *cert. denied*, 469 U.S. 824 (1984). Indeed, special trial judges enjoy greater power under federal law than do magistrates, since their trial rulings are unreviewed and even their ultimate findings and opinions are presumed correct. In contrast, magistrates may preside over a civil trial only with the consent of the parties, 28 U.S.C. § 636(c)(1), and their rulings on dispositive motions, their findings of fact and their conclusions of law are all subject to *de novo* review if any party files objections. *See, e.g., LoConte* v. *Dugger*, 847 F.2d 745, 750 (11th Cir.), *cert. denied*, 109 S.Ct. 397 (1988).

[20] The Constitution repeats many legal terms of art in its different provisions, and they are naturally understood to mean the same things each time. For example, the "Bill of Attainder," "ex post facto Law" and "Title of Nobility"

Understanding the Framers to have meant "Courts" in the Appointments Clause to denote the same institutions they described as "Courts" in Art. III, § 1, is not only the most natural reading of the Constitution's text, but also the reading recently suggested by this Court. In *Buckley* v. *Valeo*, this Court held that the Appointments Clause must be read in light of Article III's grant of judicial power to the federal "Courts." After reciting the Constitution's three great grants of Legislative, Executive and Judicial power, including Art. III, § 1's declaration that "[t]he judicial Power of the United States, shall be vested in one supreme Court, and in such inferior Courts as the Congress may from time to time ordain and establish," the Court squarely held that "[i]t is in the context of these cognate provisions of the document that we must examine the language of Art. II, § 2, cl. 2." 424 U.S. at 124. When this Court restated the command of the Appointments Clause in *Buckley*, the terms it chose were significant: "Inferior officers Congress may allow to be appointed by the President alone, by the heads of departments, or by *the Judiciary*." 424 U.S. at 132 (emphasis added). The term "Judiciary" has always been understood to refer exclusively to those judges appointed in accord with Article III. *See, e.g. id.*; *Marathon*, 458 U.S. at 70 n.25.

Although the Tax Court is undeniably an adjudicative forum, not all "courts" are created equal under the Appointments Clause. The Tax Court is not a "Court of Law" — "[i]t has no jurisdiction to exercise the broad common law concept of 'judicial power' vested in courts of general jurisdiction . . . ." *Burns, Stix Friedman & Co.* v. *Commissioner*, 57 T.C. 392, 396 (1971). It is rather a "public rights" tribunal that adjudicates matters "arising 'between the Government and persons subject to its authority in connection with the performance of the con-

mentioned in Art. I, § 9 are the same as the Bill, Law and Title denoted by those same terms in Art. I, 10. Article III courts are the only "Courts" mentioned by name in the Constitution.

stitutional functions of the executive or legislative departments.'" *Marathon*, 458 U.S. at 67-68 (quoting *Crowell* v. *Benson*, 285 U.S. 22, 50 (1932)). As such, the Tax Court is empowered to decide cases "where the Government is involved in its sovereign capacity," *Granfinanciera, S.A.* v. *Nordberg*, 109 S.Ct. 2782, 2795 (1989), when taxation and tax disputes are at stake. *Marathon*, 458 U.S. at 69 n.22; *Crowell*, 285 U.S. at 51. This Court's consistent distinction between "public rights" tribunals "'with special competence in the relevant field'" and "'a federal court of law'" of plenary jurisdiction, *Nordberg*, 109 S.Ct. at 2795 & n.9 (quoting *Atlas Roofing Co.* v. *Occupational Safety and Health Review Comm'n*, 430 U.S. 442, 455 (1977)), buttresses the proposition that the Tax Court is not a "Court of Law" within the meaning of the Appointments Clause.[21]

Thus, as the Solicitor General argued vigorously in the related *Samuels, Kramer* case, the Appointments Clause's reference to "Courts of Law" restricts the power of appointment within the federal government to Article III common law courts of plenary jurisdiction, and should therefore be understood to exclude specialized Article I legislative courts.[22]

[21] Any comparison to the territorial courts and their congressional grants of power to appoint officers would be wholly inapposite. For the Constitution does not require that the separation of the branches mandated at the federal level, "where laws of national applicability and affairs of national concern are at stake," be replicated at the level of territorial and District of Columbia governments. *Palmore* v. *United States*, 411 U.S. 389, 407-08 (1973) (federal separation of powers "give[s] way to accommodate plenary grants of power to Congress to legislate with respect to specialized [geographic] areas"). *See also O'Donoghue* v. *United States*, 289 U.S. 516, 545-48 (1933) (courts in District of Columbia may mingle Art. III power with non-judicial administrative and executive functions); *Glidden* v. *Zdanok*, 370 U.S. 530, 545-46 (1962) ("the freedom of the territories to dispense with protections deemed inherent in a separation of governmental powers was . . . fully recognized").

[22] The plainly contrary language of the Appointments Clause notwithstanding, the Tax Court held in the related *Samuels, Kramer* case that Congress may vest federal appointment power in any "lawfully created government body" even if that body does "not fit within the terms 'Heads of Departments' or 'Courts of Law.'" (A86). This notion of "anything goes" cannot be reconciled with the Constitution.

C. The Chief Judge Of The Tax Court Is Not A "Head Of Department" Within The Meaning Of The Appointments Clause.

Abandoning the position it took before the Tax Court and the Fifth Circuit, that "the Tax Court clearly qualifies as a court of law" within the meaning of the Appointments Clause, Govt.Br. in *Freytag* at 47, the government confessed error a few months later in the related *Samuels, Kramer* case in the Second Circuit and argued that the "Tax Court is a 'Department[ ]' (rather than 'Court[ ] of Law') within the meaning of the Appointments Clause and its chief judge, as the 'Head' of that 'Department,' is entitled to appoint inferior Officers." SG Br. in *Samuels, Kramer* at 34. The only ground the government could offer for treating the Tax Court as an executive agency and its chief judge as an executive officer was what it admitted was a "process of elimination": the Tax Court obviously isn't a part of the Legislative Branch, nor is it a "Court of Law," so it must be a "Department" in the Executive. *Id.* at 43-44, 48.[23] This is an *ipse dixit*, not an argument, and it is at odds with 130 years of constitutional exegesis and with the legislative history surrounding the creation of the Tax Court.

The Departments of the United States Government are identified by statute and do not include the Tax Court.[24] In *United States* v. *Germaine*, 99 U.S. 508 (1879), this Court rejected an argument that the Commissioner of Pensions was the head of a "Department" under the Appointments Clause, holding that term limited to those "'part[s] or division[s] of executive government, as the Department of State, or of the Treasury,'" expressly created and given "the name of a department" by Congress. *Id.* at 510-11. *See also id.* at 511 (term does not include commissioners or bureau officers); *Burnap* v. *United States*, 252 U.S. 512, 516 (1920) (term refers to "member[s] of the Cabinet," "not . . . heads of bureaus or lesser divisions"); *United States* v. *Mitchell*, 89 F.2d 805, 808 (D.C.Cir. 1937) (head of an "independent board or commission created by Act of Congress" is not a "head of department").[25] This construction of the term "Department" as denoting what Justice Brandeis called the "great division[s] of the executive branch," *Burnap*, 252 U.S. at 516, has also been consistently endorsed for over 130 years by the United States Attorneys General.[26]

Any procrustean attempt to stuff the Tax Court into the category of Executive "Department" would also conflict with the legislative history of the Tax Court itself. Far from designating the Tax Court an Executive "Department," in 1969 Congress expressly established the Tax Court as an "Article I" legislative "court"[27] with what the government concedes in

[23] The Tax Court's amicus before the Second Circuit, former Solicitor General Erwin Griswold, sharply criticized the argument that the Tax Court was a department within the Executive Branch. *See* Brief for *Amicus Curiae* in *Samuels, Kramer & Co.* v. *Commissioner* at 4-5, 31.

[24] *See* 5 U.S.C. § 101 (Executive "Department[s]" are: State, Treasury, Defense, Justice, Interior, Agriculture, Commerce, Labor, Health and Human Services, Housing and Urban Development, Transportation, Energy, Education and Veterans Affairs).

[25] Significantly, two of the Departments — Energy and Veterans Affairs — have been added by Congress since 1969, the year Congress changed the status of the Tax Court to an Article I court. *See* Pub.L. 100-527, § 13(b), 102 Stat. 2643 (1988); Pub.L. 95-91, Title VII, § 710(a), 91 Stat. 609 (1977). Had Congress meant to create the Tax Court as a Department, it surely would have amended 5 U.S.C. § 101, as it has every other time it has added a new Department to the executive branch or elevated a pre-existing executive entity (*e.g.*, the Bureau of Veterans Affairs, or the various sub-cabinet bureaus and departments that were consolidated into the Department of Energy).

[26] *See, e.g.*, 26 Op.Atty. Gen. 209, 211-212 (1907) (term does not include bureaus, agencies or other offices, only those "immediate superior ministerial" offices under the President designated as Departments by Congress); 11 Op.Atty. Gen. 209 (1865); 6 Op.Atty.Gen. 326, 327, 332-33, 344 (1854).

[27] Section 951 of the Tax Reform Act of 1969, Pub.L.No. 91-172, 83 Stat. 487, codified at 26 U.S.C. § 7441, provided that the Tax Court was "a court of record" established "under Article I of the Constitution." The Tax Court's predecessor, the Board of Tax Appeals, was an Executive Branch adjudicative agency. *See generally* H.Dubroff, *The United States Tax Court: An Historical Analysis* (1979). Even when deemed part of the Executive Branch, the Tax Court's predecessor was expressly designated a mere "independent agency" rather than a "Department." *See* Internal Revenue Code of 1939, 26 U.S.C. § 1100.

Samuels, Kramer was the express purpose "to distance the Tax Court from the Executive Branch," SG Br. in *Samuels, Kramer* at 46 n.37, and to remove it from Executive control. Surely a federal court may not override Congress' considered judgment and redesignate as an Executive "Department" an entity that Congress saw fit to remove from Executive control and to constitute as an Article I legislative court.[28]

D. Reading The Appointments Clause To Preclude Tax Court Appointment Of Special Trial Judges Does Not Threaten The Administrative State.

Granting the relief petitioners seek would have great importance for the operation of the Tax Court and the principle of separation of powers embodied in the Appointments Clause, but would impose virtually no inconvenience upon the federal government. *First*, there need be no concern that the relief petitioners seek might cripple the Tax Court, for the constitutional flaw here could be easily remedied. Upon invalidation of the current method of appointing special trial judges, Congress could simply expand the Tax Court to include additional judges to be appointed in accord with the Appointments Clause as are the current Tax Court judges. This was the route Congress chose when it took it upon itself to change the Claims

[28] The legislation makes plain Congress' intent to strip the Tax Court even of its previous identity as a mere "executive agency," rather than to elevate it to the level of a full Executive "Department." Staff of the Joint Committee on Internal Revenue Taxation, 91st Cong., 2d Sess., *General Explanation of the Tax Reform Act of 1969* 262-63 (Joint Committee Print 1970). "Since the Tax Court had only judicial duties, Congress believed it anomalous to continue to classify it with quasi-judicial executive agencies that have rule-making and investigatory functions." *Id.* at 262. Furthermore, under Art. II, § 2, the President "may require the Opinion, in writing, of the principal officer in each of the executive Departments," yet one of the reasons for transforming the Tax Court into an Article I tribunal was to eliminate the need for the Court to respond to Executive inquiries pertaining to executive supervisory or budgetary authorities, a task that was cumbersome and often irrelevant to the Tax Court's adjudicative duties. *See* Dubroff, *supra*, at 190 & n.177.

Court from an Article III to an Article I tribunal in 1982.[29] Or the special trial judges could be appointed as inferior officers by "the President alone." Art. II, § 2. Either resolution would be practicable and, more importantly, consistent with the narrow scope and most natural reading of the Appointments Clause.

Second, this case poses no challenge whatsoever to the existence of the so-called "fourth branch" of the federal government. There is no issue here of the legitimacy of Article I courts, Executive agencies, or independent agencies and commissions.

Third, the reading of the Appointments Clause urged by petitioners poses no significant disruption to the way in which seemingly similar positions elsewhere in the federal government are filled, because virtually all other adjudicatory officers and agents in the federal government are distinct from Tax Court special trial judges and would therefore be unaffected by a decision in this case.

The appointment power of the Article III judiciary (who are undoubtedly "Courts of Law") is unquestioned; so, for example, federal magistrates, bankruptcy judges and Article III special masters are unaffected by petitioners' argument. *See* 28 U.S.C. §§ 152, 631(a); *Ex Parte Peterson*, 253 U.S. 300, 312-14 (1920). The appointment power that the Heads of the Executive Departments may wield pursuant to congressional grant is likewise unquestioned.

Executive branch subcabinet agencies, commissions and independent agencies would similarly be untouched by the result petitioners urge. The adjudicatory agents in these organs of government are administrative law judges ("ALJs") who are

[29] See Pub.L. 97-164, Title I, § 121(b), 96 Stat. 34 (April 2, 1982). The offices of the fifteen Claims Court commissioners (appointed by the Claims Court when it was an Article III tribunal) were eliminated. But the Court itself was expanded from seven to sixteen judges to compensate for the increased workload. *See also* 28 U.S.C. § 171.

part of the competitive civil service and are expressly and aptly designated "employees," rather than "inferior officers," by the relevant legislation and rules.[30] Other agency appointees are likewise employees, such as, for example, the "officers, attorneys, examiners, and other experts" whom the Securities and Exchange Commission is "authorized to appoint and fix the compensation of," often "subject to the civil-service laws." 15 U.S.C. § 78d(b). None of the personnel these agencies and commissions "appoint" are "officers" within the meaning of the Appointments Clause, because their positions, duties, functions and compensation are left up to the agencies rather than "established by law." [31] In contrast, the position of special trial judge is explicitly created by statute and the jurisdiction, duties, compensation and even the travel expense allowances appurtenant to the office are carefully defined by Congress. 26 U.S.C. § 7443A (A100). Moreover, special trial judges enjoy sweeping, effectively unreviewed adjudicative power in many categories of cases and, in the § 7443A(b)(4) category at issue here, in practice exercise power virtually coextensive with that held by Tax Court Judges themselves.

The only effect petitioners' argument could have is on other statutorily authorized and defined officers appointed by Article I courts. The only example of which petitioners are aware is

[30] The Administrative Procedure Act expressly denominates the ALJs "presiding *employees*." 5 U.S.C. §§ 554(d), 556(b) & (c), 557(b) (emphasis added). *See also* 5 C.F.R. § 930.201(b) (ALJ is a competitive civil service position). ALJs take competitive exams, 5 U.S.C. § 1104(a)(2); are paid according to civil service pay scales, 5 U.S.C. §§ 5335(a)(B), 5372; and are hired, fired, and transferred among agencies pursuant not to the whims of the agency and commission heads but to the regulations and authority of the Office of Personnel Management, 5 U.S.C. §§ 1305, 3344, 7521; 5 C.F.R. § 930.203a(a).

[31] *See, e.g., United States* v. *Maurice*, 26 Fed.Cas. at 1214-15 (statute directing Secretary of War to prepare regulations defining duties and powers of enumerated personnel "cannot be construed to extend to the establishment of offices"); *Burnap* v. *United States*, 252 U.S. at 516; *Auffmordt* v. *Hedden*, 137 U.S. 310, 327 (1890) (employees are "lesser functionaries subordinate to officers of the United States").

an inferior officer that the Executive Branch itself has already identified as having been appointed in violation of the Appointments Clause. This is a recently created group of special masters in the United States Claims Court, now an Article I court, charged with jurisdiction over claims arising under the National Vaccine Injury Compensation Program. 42 U.S.C. §§ 300aa-11, 300aa-12(a). These masters are appointed by the Claims Court, § 300aa-12(c)(1), and their tenure, compensation, jurisdiction and duties — like that of Tax Court special trial judges — are carefully defined by statute. *See* § 300aa-12. The special masters' proposed findings of fact and conclusions of law must be presumed correct by the Claims Court and may be set aside only if arbitrary or capricious. § 300aa-12(e)(2)(B); *Hanagan* v. *Secretary*, 19 Cl.Ct. 7, 15-16 (1989).

The vaccine special masters, like Tax Court special trial judges, are inferior officers of the United States whose method of appointment violates Article II, § 2 because the Claims Court, like the Tax Court, is neither a "Department" nor a "Court of Law." As the President himself noted upon signing the bill creating the vaccine masters, the bill "vest[s] significant authority pursuant to the laws of the United States in persons whose appointment and removal are inconsistent with the requirements of Article II . . . ." [32] The President directed the Attorney General and the Secretary of Health and Human Services to submit legislation to correct the problem. (A103). It is worth emphasizing that the Justice Department has admitted that its analysis of the Appointments Clause in the Fifth Circuit below cannot be reconciled with this formal statement by the President that Article I tribunals such as the Tax Court cannot wield appointment power under Art. II, § 2. (*See* A102-03).

[32] Statement of the President on Signing the Omnibus Budget Reconciliation Act of 1989, 25 Weekly Comp. of Pres. Docs. 1970-1 (Dec. 19, 1989). Pertinent portions of the statement are reprinted in Appendix G. (A103).

Thus the extent of the change that petitioners' reading of the Appointment Clause would have on the federal government is meager.

E. This Constitutional Objection Cannot Be And Has Not Been Waived.

Although the Appointments Clause issue was briefed and argued by both parties below, the Fifth Circuit declined to reach the merits of the argument, dismissing it with the observation that, "[b]y consenting to the assignment of their case at the time it was made, the Taxpayers waived this objection." (A.8 n.9). This ruling is plainly incorrect.[33]

1. An argument premised on the Constitution's structural separation of powers is not a matter of personal rights and therefore is not waivable.

This Court has consistently held that objections to judicial procedure based on the Constitution's structural provisions, such as the Appointments Clause, cannot be waived, in contrast to assertions of personal rights under the Constitution. The court below committed plain error by confusing these two categories. A constitutional provision safeguarding a "personal right," such as "Article III's guarantee of an impartial and independent federal adjudication[,] is subject to waiver, just as are other personal constitutional rights that dictate the procedures by which civil and criminal matters must be tried." *CFTC* v. *Schor*, 478 U.S. 833, 848-49 (1986). But if a provision "also serves as 'an inseparable element of the constitutional system of checks and balances,'" it cannot be waived.

[33] Moreover, this ruling is flatly inconsistent with the Fifth Circuit's simultaneous decision to reach and decide petitioners' statutory argument that the special trial judge could not be assigned this case — an argument that, by the court's own reasoning, should likewise have been "waived" by consent to the assignment to the special trial judge if such objections are indeed waivable. (A7).

Id. at 850. *See also Pacemaker Diagnostic Clinic* v. *Instromedix*, 725 F.2d at 543-44 ("The component of the separation of powers rule that protects the integrity of the constitutional structure, as distinct from the component that protects the rights of the litigants, cannot be waived by the parties"). When a

> structural principle is implicated in a given case, the parties cannot by consent cure the constitutional difficulty for the same reason that the parties by consent cannot confer on federal courts subject matter jurisdiction beyond the limits imposed by Article III, § 2. . . . [N]otions of consent and waiver cannot be dispositive because the limitations serve institutional interests that the parties cannot be expected to protect.

CFTC v. *Schor*, 478 U.S. at 850-51.[34] Indeed, such objections will be heard and decided even when — unlike the present case — there is evidence that the objecting party deliberately delayed raising the issue until the case was decided against him.[35]

[34] Accordingly, this Court reached and decided the structural Article III issue in *Schor* even though "Schor indisputably waived any right he may have possessed" to an Article III tribunal by "expressly demand[ing]" that the case proceed before the CFTC. 478 U.S. at 849.

[35] Schor's structural objection based on the separation of powers was deemed unwaivable even in the face of abuse by the party. As this Court noted, Schor "was content to have the entire dispute settled in the forum he had selected until the ALJ ruled against him on all counts; it was only after the ALJ rendered a decision to which he objected that Schor raised any challenge to the CFTC's consideration of [his opponent's] counterclaim." 478 U.S. at 849. *See also Glidden* v. *Zdanok*, 370 U.S. 530, 535-36 (1962) (usual rule "preventing litigants from abiding the outcome of a lawsuit and then overturning it if adverse upon a technicality of which they were previously aware" does "not obtain" when the defect is "jurisdictional" or "is based upon nonfrivolous constitutional grounds").

This case parallels the circumstances in *Pacemaker Diagnostic Clinic* v. *Instromedix*, where a party challenged a magistrate's power to preside over a civil trial and enter the final judgment, despite that party's formal consent to the procedure. In reaching the merits of the constitutional challenge, Judge (now Justice) Kennedy wrote for the *en banc* court that "[s]tatutes or governmental actions which violate the separation of powers doctrine in its systemic aspect should be invalidated, as a general rule, despite waiver by affected private parties." 725 F.2d at 544. The Appointments Clause objection raised by petitioners here is an equally fundamental part of the Constitution's structure and likewise cannot be waived. Indeed, in *Glidden* v. *Zdanok*, this Court expressly included Appointments Clause objections to judicial officers in the category of structural constitutional objections that cannot be waived:

> [I]n *Lamar* v. *United States*, 241 U.S. 103, 117-18, the claim that an intercircuit assignment . . . usurped the presidential appointing power under Art. II, § 2, was heard here and determined upon its merits, despite the fact that it had not been raised in the District Court or in the Court of Appeals or even in this Court until the filing of a supplemental brief upon a second request for review.

370 U.S. at 536.[36]

[36] The government argued below that *Glidden* is inapposite because the judges whose appointments were challenged there had either "cast the deciding vote" in an appeal or had "entered the judgment of conviction." Govt. Brief in *Freytag* at 37 n.33. The supposed distinction is without merit. The special trial judge in this case presided over 75% of the trial and wrote the findings and opinion that were "presumed correct" and summarily adopted verbatim by the Tax Court. As this Court has unanimously recognized, litigants are entitled to have "all critical stages" of their judicial proceedings "conducted by a person with jurisdiction to preside." *Gomez* v. *United States*, 109 S.Ct. at 2248.

2. Even if this objection were waivable, there was no uncoerced consent to the special trial judge's authority in this case.

In any event, petitioners' acceptance of the assignment of a special trial judge to complete the trial in this case cannot, under the circumstances, be deemed free and voluntary consent. Even if the Appointments Clause were not a structural element of the Constitution and conferred purely personal rights, it remains the law that a "waiver of personal rights must, of course, be freely and voluntarily undertaken." *Pacemaker*, 725 F.2d at 543. As Judge Kennedy explained in that case, which involved the issue of a magistrate's authority to conduct a civil trial with the parties' consent:

> The purported waiver of the right to an Article III trial would not be an acceptable ground for avoiding the constitutional question if the alternative to the waiver were the imposition of serious burdens and costs on the litigant. If it were shown that the choice is between trial to a magistrate or the endurance of delay or other measurable hardships not clearly justified by the needs of judicial administration, we would be required to consider whether the right to an Article III forum had been voluntarily relinquished.

725 F.2d at 543.

Petitioners were plainly faced with just such a Hobson's choice here. Petitioners began the trial in this case before a duly-appointed Tax Court judge (Judge Wilbur, whose jurisdiction they have never questioned) and originally consented only to allow a special trial judge to act as an evidentiary referee in the courtroom while the ailing Judge Wilbur viewed the videotapes at home and remained in charge of the case. When

Judge Wilbur took a disability retirement from the Tax Court, the petitioners had been wrestling with the trial for 16 months and had no meaningful choice but to allow the special trial judge to take charge of the case and prepare findings and an opinion. The alternative was to start all over again and simply scrap a trial that had already generated thousands of pages of transcript, hundreds of hours of videotape and numerous exhibits, and that had already consumed hundreds of thousands of dollars in costs and attorneys fees. The "imposition of [these] serious burdens and costs on the litigant" makes petitioners' decision to proceed before the special trial judge involuntary and lacking in consent. *Pacemaker*, 725 F.2d at 543.[37]

CONCLUSION

The statutory and constitutional questions presented by this case have enormous implications for the operation of the Tax Court and thousands of its pending cases. These questions have also generated extraordinary confusion within the government itself over the constitutional status of Article I courts under the Appointments Clause. These issues merit the plenary attention of this Court. That the constitutional issue was not addressed on the merits by the court below need not stand in the way. As Justice Harlan once wrote for this Court, even "the disruption to sound appellate process entailed by entertaining objections *not* raised below" is "plainly insufficient to overcome the strong interest of the federal judiciary in maintaining the constitutional plan of separation of powers." *Glidden* v. *Zdanok*, 370 U.S. at 536 (emphasis added). It is far more appropriate to reach and decide such an issue where, as here, the petitioners *did* raise and brief it below, only to have the court below invoke spurious reasons for refusing to reach it. Therefore, a writ should be granted.

In the alternative, this case should be held pending final resolution in this Court of these same issues in the related *Samuels, Kramer* litigation, which is currently under submission in the Second Circuit.

Respectfully submitted,

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[37] Nor can petitioners be said to have voluntarily relinquished their rights to trial before a constitutionally appointed judicial officer by taking their cases to the Tax Court. *First*, they consented to have their cases resolved by legitimate Tax Court judges, not by a special trial judge assigned in violation of the governing statute and appointed in violation of the Appointments Clause. At least with respect to the statutory argument, the court below agreed that the objection goes to subject matter jurisdiction and is therefore unwaivable. (A7); *see* note 33, *supra*. *Second*, if it were the law that one waived any constitutional objection to Tax Court procedures simply by filing a petition with that tribunal, then *all* plaintiffs in *all* fora could be said to have "waived" *any* constitutional or jurisdictional objections by virtue of their decision to litigate. But the law is otherwise. However sweeping the congressional power to "prescribe the conditions on which it will subject" the government to suit, *Cheatham* v. *United States*, 92 U.S. 85, 89 (1876), Congress cannot prescribe conditions that violate a *structural* constitutional provision such as the Appointments Clause. *See Buckley* v. *Valeo*, 424 U.S. 1, 133 (1976) (plenary authority of Congress over election practices does not give Congress leave to employ that authority in a manner that transgresses "well-established constitutional restrictions stemming from the separation of powers").

TABLE OF CONTENTS

APPENDIX H

APPENDIX A.

Thomas L. FREYTAG and Sharon N. Freytag, Petitioners-Appellants,

v.

COMMISSIONER OF INTERNAL REVENUE, Respondent-Appellee.

Joe D. WOMBLE and Gladys E. Womble, Petitioners-Appellants,

v

COMMISSIONER OF INTERNAL REVENUE, Respondent-Appellee.

Bert C. TIMM and Mildred H. Timm, Petitioners-Appellants,

v.

COMMISSIONER OF INTERNAL REVENUE, Respondent-Appellee.

Kenneth G. McCOIN and Candace G. McCoin, Petitioners-Appellants,

v.

COMMISSIONER OF INTERNAL REVENUE, Respondent-Appellee.

Nos. 89-4436, 89-4439, 89-4440 and 89-4450.

United States Court of Appeals, Fifth Circuit

July 6, 1990

Appeals from the Decision of the United States Tax Court.

Before GEE, POLITZ, and JONES, Circuit Judges.

POLITZ, Circuit Judge:

Thomas and Sharon Freytag, Joe and Gladys Womble, Bert and Mildred Timm, and Kenneth and Candace McCoin (Taxpayers) appeal adverse deficiency determinations made against them by the Tax Court. The court disallowed the Taxpayers' deductions for losses allegedly incurred as the result of investments in a commodity straddle program on the grounds that the program was composed of sham transactions or, alternatively, that the Taxpayers did not enter into these transactions primarily for economic profit. Finding error of neither law nor fact, we affirm.

Background

The Taxpayers are four of approximately 3,000 taxpayers who have sought redetermination of deficiencies assessed against them for deducting losses allegedly realized from investments in straddles in forward contracts to buy and sell securities issued by the Government National Mortgage Association (GNMAs) and the Federal Home Loan Mortgage Corporation (FMACs).[1] The straddle portfolios in which the Taxpayers invested were all part of a computer-generated investment program offered by First Western Government Securities

[1] In a forward contract, as in a futures contract, an investor agrees to purchase (a long position) or sell (a short position) an underlying security on a specific date. A straddle investor holds an equal number of long and short positions in the same underlying security—the "legs" of the straddle. In theory, a straddle results in both tax deferral and conversion of ordinary income into capital gain by enabling an investor to close out one leg at a loss and offset this loss against ordinary income, while holding the gain leg open until a later year.

(First Western), formed in 1978 by Sidney Samuels, an attorney and former Internal Revenue Service agent.[2]

We summarize the findings of the Tax Court, detailed in its exhaustive opinion, ***Freytag v. Commissioner***, 89 T.C. 849 (1987), as follows: First Western identified prospective investors by using accountants, lawyers, and financial consultants it referred to as "finders." All First Western investors signed a customer agreement stating that First Western

> may without demand for margin, whenever in [its] discretion [it] deem[s] it advisable for my or [its] protection, sell any or all securities or commodities held in any of my accounts . . ., and [it] may borrow or buy any securities or commodities required to make delivery against any sale effected for me . . . Such sale or purchase may be public or private and may be without . . . notice to me and in such manner as [it] may in [its] discretion determine.

Investors informed First Western of their "tax preference," the amount of tax loss or long-term capital gain they wished to secure. First Western would respond by recommending portfolios of straddles based upon the requested tax-motivated action and the time remaining in the tax year.[3] Because of the high risk involved, the forward contract market in GNMAs and FMACs is dominated by institutional investors. Individual contracts in excess of $1.8 million in size and six months in duration are rare. The portfolios offered by First Western,

[2] Initially, Samuels also formed Samuels & Co. (later Samuels, Kramer & Co.), which served as the "investment advisor" in the First Western program. Because this function was absorbed into First Western at a later date, we omit discussion of Samuels & Co.

[3] The record does not indicate that any investor error refused to approve First Western's suggested portfolios.

however, had delivery dates ranging from 14 to as many as 30 months; those purchased by the Taxpayers involved over $1.6 billion.

In the typical scenario, investors would provide First Western with a "margin" deposit. Although a margin typically neither limits an investor's potential liability nor is linked to tax considerations, the "margins" paid by First Western's investors were a percentage of their desired tax loss and represented their total liability for trading losses. First Western assessed trading fees against the "margin" until a stated "fee cap" was reached, after which no fees were assessed.

As either buyer or seller, as necessary in *every* transaction with its investors, First Western's unilaterally set all prices. The Tax Court found that the predicates underlying First Western's pricing algorithm ensured that all of its contract prices would move in tandem with the price of the GNMA 9½% coupon and in lockstep with each other.

It is the norm that marketplace investors enter into forward contracts intending to take or make delivery of the underlying security on a specified date. The mere possibility of delivery links the forward market to the cash market in the underlying securities. Delivery never occurred in the First Western program; in fact, First Western's computer program contained no delivery provision.

In lieu of delivery, and as a key element of its program, First Western closed out its investors' positions by cancellation or assignment, methods typically reserved for other kinds of situations.[4] When the loss leg of an investor's straddle achieved the desired tax loss, First Western would cancel the contract to ensure the investor a tax loss for the year.[5] Once the gain leg

[4] Cancellation typically is used to rescind a transaction in the event of error. Assignment typically is used to effect delivery of an underlying security to a third party to whom the purchaser is obligated.

[5] Because cancellation does not involve a sale or exchange, any losses incurred constitute ordinary tax losses.

generated the desired amount of capital gain, First Western would assign the contract to one of three financial entities maintaining an account with it for this specific purpose. First Western closed out the contract with the assignee, credited the assignee's account with one percent of the proceeds, and credited the remaining 99 percent to the investor. No money changed hands.

First Western successfully obtained tax losses for its investors remarkably close to their stated tax preferences.[6] Unfortunately for the Taxpayers, however, the Commissioner marched to a different "tax preference" drummer. The Commissioner determined First Western's program to be a sham and denied the deduction of losses resulting from its transactions. Some 3,000 taxpayers petitioned the Tax Court for a redetermination. The Taxpayers were among ten test cases selected for a consolidated trial, which began in December 1984 before Judge Richard Wilbur. Judge Wilbur fell ill and Chief Justice Sterrett

[6] In those years for which the information is available, the Tax Court found the Taxpayers' desired tax losses and those obtained by First Western to be as follows:

	Requested tax loss		Actual loss
Freytag	$ 70,000	(1979 short term capital loss)	$ 70,539
	100,000	(1979 ordinary loss)	99,403
	100,000	(1980 ordinary loss)	101,794
	130,000	(1981 ordinary loss)	126,188
	140,000	(1982 ordinary loss)	143,001
McCoin	100,000	(1980 ordinary loss)	102,272
Timm	50,000	(1978 ordinary loss)	50,476
	50,000	(1979 short-term capital loss)	58,669
	60,000	(1980 ordinary loss)	62,004
	75,000	(1980 short-term capital loss)	77,611
	85,000	(1981 ordinary loss)	84,523
Womble	280,000	(1980 ordinary loss)	284,744
	131,500	(1981 ordinary loss)	131,682

The margin deposits for the above transactions amounted to $71,500 (Freytag), $10,000 (McCoin), $36,050 (Timm), and $54,000 (Womble).

assigned the cases to a special trial judge for purposes of conducting the trial. Proceedings before the special trial judge were videotaped so Judge Wilbur could review testimony at home.

Judge Wilbur took senior status and the chief judge advised the parties that unless they objected, he intended to assign their cases to the special trial judge for preparation of a report in accordance with 26 U.S.C. § 7443A. One corporate petitioner objected and its trial was severed. Those remaining agreed to the reassignment with the understanding that Judge Wilbur or the chief judge would issue the opinion of the Tax Court, as required by § 7443A(c). The special trial judge filed a proposed opinion finding First Western's transactions to be a sham or, alternatively, that its investors' losses were not deductible because they had not entered into the transactions primarily for profit. The special trial judge also recommended the levying of negligence assessments against the Taxpayers. The chief judge formally adopted the proposed opinion as the decision of the Tax Court. Following two unsuccessful motions for reconsideration, the Taxpayers appealed.

Analysis

1. Jurisdiction of the special trial judge.

Pursuant to 26 U.S.C. § 7443A the chief judge of the Tax Court may appoint special trial judges to preside over (1) any declaratory judgment proceeding, (2) any proceeding conducted under section 7463, (3) any proceeding where neither the amount of deficiency in dispute nor any claimed overpayment exceeds $10,000, and (4) "any other proceeding" so designated by the chief judge. 26 U.S.C. § 7443A(b)(1)-(4). In the first three categories, the court may authorize the special trial judge to render a decision. 26 U.S.C. § 7443A(c). Special trial judges

may not render the formal decision of the Tax Court in cases assigned under the fourth category.

In the instant case, which fell under the "any other proceedings" category, the special trial judge filed his report on October 21, 1987. The chief judge adopted this report as the Tax Court's opinion and formally filed the decision that same day. The Taxpayers contend that by adopting the proposed opinion on the same day it was filed the chief judge in effect permitted the special trial judge to render the "decision" of the Tax Court contrary to 26 U.S.C. § 7443A(c). Inasmuch as this argument is, in essence, an attack upon the subject matter jurisdiction of the special trial judge,[7] it may be raised for the first time on appeal. *C.F. Dahlberg & C. v. Chevron U.S.A., Inc.*, 836 F.2d 915 (5th Cir. 1988).

Our analysis begins and ends with the simple fact that the opinion in this case was issued by the Tax Court in the name of the chief judge. The chief judge had both the obligation and power to maintain full responsibility for the decision in this case. Tax Ct. R. 183(c).[8] We will assume that the judge did

[7] There is no question that the Taxpayers properly invoked the subject matter jurisdiction of the Tax Court when they elected to seek redetermination of their tax liability rather than paying the tax and seeking a refund in federal district court. 26 U.S.C. §§ 6214, 7442.

[8] Although Tax Court Rule 183(c) indicates that the special trial judge's recommended findings of fact shall be presumed correct, it is the division of the Tax Court to which the case is formally assigned that controls the outcome of the case. That division

> may adopt the Special Trial Judge's report or may modify it or may reject it in whole or in part, or may direct the filing of additional briefs or may receive further evidence or may direct oral argument, or may recommit the report with instructions. . . .

Tax Ct. R. 183(c). *But cf. Stone v. Commissioner*, 865 F.2d 342 (D.C.Cir. 1989) (Tax Court must follow the special trial judge's findings of fact unless clearly erroneous). At the time the case under review in *Stone* was decided in the

so in good faith. The record before us is devoid of any evidence that even remotely suggests otherwise, other than the short time span between the filing of the special tax judge's report and the issuance of the Tax Court's opinion by its chief judge.[9]

2. The Tax Court's determination of sham transactions.

The fundamental premise underlying the Internal Revenue Code is that taxation is based upon a transaction's substance rather than its form. Thus sham transactions are not recognized for tax purposes, and losses allegedly generated by such transactions are not deductible. *See e.g., Gregory v. Helvering*, 293 U.S. 465, 55 S.Ct. 266, 79 L.Ed. 596 (1935); ***Forseth v. Commissioner***, 845 F.2d 746 (7th Cir. 1988); ***Enrici v. Commissioner***, 813 F.2d 293 (9th Cir. 1987); ***Bramblett v. Commissioner***, 810 F.2d 197 (5th Cir. 1987) (unpub. op.); ***Mahoney v. Commissioner***, 808 F.2d 1219 (6th Cir. 1987); ***Wooldridge v. Commissioner***, 800 F.2d 266 (11th Cir. 1986) (unpub. op.). Whether a particular transaction is a sham is a question of fact reviewed under the clearly erroneous standard. *Forseth*, 845 F.2d at 748; *Enrici*, 813 F.2d at 295; *Mahoney*, 808 F.2d at 1220.

Although the Tax Court found that no one "gremlin" mandated the conclusion that First Western's program was designed to create sham transactions, it could not help but reach this conclusion in light of the multitude of "gremlins" with which it was confronted. Although they raise several related claims,[10] the Taxpayers primarily contend that the Tax Court's finding that the First Western program was a sham was clearly erroneous in light of the testimony of their own expert witnesses who, they insist, presented unrebutted proof that First Western's contract prices would be considered reasonable in the open market.

Tax Court, litigants were furnished with a copy of the special trial judge's proposed opinion and filed exceptions thereto. According to counsel for the Commissioner, litigants are no longer afforded this opportunity; this change in rules, in our view, confirms that the Tax Court's relationship with its special trial judges cannot be analogized to typical appellate review.

[9] Also for the first time on appeal the Taxpayers challenge the constitutionality of section 7443A under the Appointments Clause of the Constitution. By consenting to the assignment of their case at the time it was made, the Taxpayers waived this objection.

To demonstrate the off-market nature of First Western's pricing methodology, the experts called by the Commissioner compared market prices of forward contracts for immediate settlement with the prices resulting from the application of First Western's formula to the same type of contract. The Taxpayers assert that the court's reliance on these analyses was clearly erroneous because First Western traded only in long-term forward contracts. Although First Western did not trade in immediate forward contracts, it is undisputed that there is no market for the 14-to-30-month contracts utilized in the First Western program. Accordingly the only way to compare First Western's prices with market prices was through an analysis of the kind of instruments which in fact were traded in the market.

Were we to assume, *arguendo*, that First Western's pricing formula produced contract prices sufficiently tracking those in the open commodities market, the fact remains that the Taxpayers surrendered total control to First Western over invest-

[10] The Taxpayers contend that the Tax Court failed to consider any evidence, particularly that of their expert witnesses, relating to their actual transactions with First Western. This contention is without merit. Although it stated that it declined to "delve into the minutiae of the transactions" at issue, the Tax Court explored in detail the dealings of each of the Taxpayers with First Western. Further, inasmuch as all of the deductions at issue stemmed from a common source, the simultaneous assessment of the general functioning of First Western's program was probative of their validity. *See Sochin v. Commissioner*, 843 F.2d 351 (9th Cir. 1988), *cert. denied*, ___ U.S. ___, 109 S.Ct. 72, 102 L.Ed.2d 49 (1988); *Forseth, supra; Enrici, supra; Mahoney, supra.*

ments that, in the real market, are so risky as to be virtually non-existent. As the Ninth Circuit recognized under similar circumstances in *Sochin v. Commissioner, supra*, "no reasonable investor would surrender total control of his or her ability to profit or lose unless satisfied that the risk of loss had been greatly diminished ~~or~~ eliminated." *Sochin*, 843 F.2d at 356.

First Western's absolute authority over the pricing and timing of the transactions that occurred in the self-contained market of its own making enabled it to achieve the tax losses desired by its investors with uncanny accuracy. The Tax Court's recognition that First Western's program made available to its investors an essentially risk-free opportunity to purchase tax deductions cannot be labeled clearly erroneous. *See United States v. United States Gypsum Co.*, 333 U.S. 364, 395, 68 S.Ct. 525, 542, 92 L.Ed. 746 (1948) (fact findings will remain undisturbed unless a review of the evidence leaves "the definite and firm conviction that a mistake has been committed"). Bathed in the harsh light of economic reality the Taxpayers' other factual arguments amount to nothing more than a valiant effort to substitute the testimony of their expert witnesses for the findings of the Tax Court.

3. Deductibility of losses under § 108.

The deductibility of pre-1982 commodity straddles is governed by section 108(a) of the Tax Reform Act of 1984, Pub.L. No. 98-369, § 108, 98 Stat. 494, 630 (1984), as amended by section 1808(d) of the Tax Reform Act of 1986, Pub.L. No. 99-514, 100 Stat. 2085, 2817 (1986). Section 108(a) permits the deduction of a loss if such loss is incurred in a trade or business, or if such loss is incurred in a transaction entered into for profit though not connected with a trade or business . . .

Applying section 108(a) to the Taxpayers' transactions with First Western, the Tax Court held in the alternative that even if the transactions generated by First Western were not shams, the losses in question were nonetheless not deductible because the Taxpayers had not entered into the transactions with a primary motive of economic profit.

Taking exception to the primary motive test applied by the Tax Court, the Taxpayers contend that section 108(a) requires only that their transactions have had a "reasonable prospect of profit." Although this argument does not affect the Taxpayers' liability in light of our affirmance of the Tax Court's sham determination, we conclude that we ought to address it briefly, for purposes of comprehensiveness, even if only to reject it. This circuit, along with every other circuit plumbing congressional intent underlying section 108(a), has held losses to be deductible under that provision only if the taxpayer entered into the transaction primarily for profit. *See Killingsworth v. Commissioner*, 864 F.2d 1214 (5th Cir. 1989); *Dewees v. Commissioner*, 870 F.2d 21 (1st Cir. 1989); *Friedman v. Commissioner*, 869 F.2d 785 (4th Cir. 1989); *Kirchman v. Commissioner*, 862 F.2d 1486 (11th Cir. 1989); *Landreth v. Commissioner*, 859 F.2d 643 (9th Cir. 1988); *Miller v. Commissioner*, 836 F.2d 1274 (10th Cir. 1988).[11]

4. Additions to tax for negligence under section 6653(a).

Finally, the Taxpayers attack the Tax Court's determination that they were liable for negligence penalties pursuant to 26

[11] Again, the Taxpayers contend that the Tax Court reached this conclusion without consideration of the specific transactions in which they engaged. Again, this contention is without merit. The Tax Court's assessment of their primary motivation was made against a backdrop of extensive findings regarding the Taxpayers' dealings with First Western. In light of all the evidence, the Tax Court was fully justified in its conclusion that "it is simply ludicrous to suggest that these petitioners had anything but a most fleeting interest in a potential economic gain."

U.S.C. § 6653(a). Once the Commissioner has determined that a negligence penalty is appropriate, the taxpayer bears the burden of establishing the absence of negligence. *Marcello v. Commissioner*, 380 F.2d 499 (5th Cir. 1967), *cert. denied*, 389 U.S. 1044, 88 S.Ct. 787, 19 L.Ed.2d 835 (1968). The Tax Court found that the Taxpayers had failed to discharge this burden. We agree.

All of the Taxpayers were professionals with investment experience that should have alerted them to the questionable financial validity of the First Western program. As the Tax Court found, however, this was not the case. Womble and Timm, who demonstrated no understanding of the way in which straddles and forward contracts function, failed to take even the most rudimentary steps to investigate the bona fides of the financial aspects of the First Western program — despite the fact that, under the literal terms of the forward contracts they purchased, they could have been required to take or make delivery of millions of dollars' worth of GNMAs or FMACs. Instead, they relied upon the advice of their "finders," who apparently had no expertise whatsoever in the financial aspects of the portfolios involved. We cannot conclude that the court's assessment of the negligence penalty against Womble and Timm was clearly erroneous.

As "finders themselves, Freytag and McCoin had even more reason to question the validity of the First Western program. Despite claims that they engaged in extensive investigation before investing in First Western, neither disputes the Tax Court's finding that they both were aware that the so-called margin deposit was a charade and that First Western's program was "controlled to the point that any meaningful risk was virtually nonexistent." We affirm as well, therefore, the Tax Court's assessment of negligence penalties against Freytag and McCoin.[12]

The decision of the Tax Court is in all respects AFFIRMED.

[12] The Taxpayers also contest on due process grounds the retroactive application of the interest penalty for tax-motivated transactions under 26 U.S.C. § 6621(c). Inasmuch as they raised this motion for the first time in the Tax Court by way of a second motion for reconsideration, the court did not abuse its discretion in refusing to address the issue. Nor will we.

APPENDIX B.

United States Tax Court.

THOMAS L. FREYTAG AND SHARON N. FREYTAG, ET AL., PETITIONERS v. COMMISSIONER OF INTERNAL REVENUE, RESPONDENT

Docket Nos. 4934-82, 9307-82, 27146-82, 29012-82, 1240-83, 3250-83, 8616-83, 33016-83, 204-84, 3749-84, 7658-84, 11821-84. Filed October 21, 1987.

OPINION

STERRETT, *Chief Judge*: This case was assigned to Special Trial Judge Carleton D. Powell pursuant to the provisions of section 7456(d) (redesignated as section 7443A(b) by the Tax Reform Act of 1986, Pub. L. 99-514, section 1556, 100 Stat. 2755) and Rule 180 et seq.[1] The Court agrees with and adopts the opinion of the Special Trial Judge that is set forth below.

OPINION OF THE SPECIAL TRIAL JUDGE

POWELL, *Special Trial Judge*.: There are currently more than 3,000 cases in this Court that involve the issues presented in these cases. The common denominator of all the cases is that each petitioner entered into alleged financial transactions involving forward contracts for Government mortgage-backed securities with First Western Government Securities (First

[1] All statutory references (except as to sec. 108 of the Tax Reform Act of 1984) are to the Internal Revenue Code of 1954 as amended, and as in effect during the years in issue, and all Rule references are to the Tax Court Rules of Practice and Procedure, except as otherwise provided.

Western). These cases were selected as so-called test cases.[2] As we view the cases, the primary issues for decision are: (1) Whether these transactions should be recognized for Federal income tax purposes, (2) if so, whether they were entered into for profit under the standard set forth in section 108 of the Tax Reform Act of 1984, as amended, and (3) whether certain petitioners are liable for additions to tax for negligence.

FINDINGS OF FACT

A. *First Western, the Supporting Characters, and the Program*

First Western is an Illinois corporation with offices in New York, New York, and San Francisco, California. Its president and sole shareholder, Sidney Samuels. Mr. Samuels holds a law degree. He was a revenue agent of the Internal Revenue Service and subsequently was in private practice in California until 1977. In 1977, he became a general partner in Price & Co.,[3] a dealer in stock options. In 1978, he formed Samuels & Co. (later Samuels, Kramer & Co.) and First Western. Samuels & Co. was an investment advisory company specializing in the futures markets. First Western is described by Mr. Samuels as a dealer in Government securities. From 1978 to mid-1980, Samuels & Co. advised customers with respect to transactions with First Western by recommending "portfolio selections" of forward contracts based on the customer's interest rate forecast. After that time, First Western took over the functions of Samuels & Co.

[2] The years and deficiencies involved, residences of petitioners at the time the petitions were filed, and respondent's adjustments are set forth in the Appendix.

[3] See *Price v. Commissioner*, 88 T.C. 860 (1987).

In 1978, First Western began marketing portfolios of "forward contracts" for securities of the Government National Mortgage Association (GNMAs) and the Federal Home Loan Mortgage Corporation (FMACs).

GNMA Securities, also commonly referred to as "Ginnie Mae's," are registered certificates which represent undivided interests in a specified pool of mortgages guaranteed by GNMA, the Veteran's Administration, the Federal Housing Administration, or the Farmers Home Administration. These pools contain approximately $1 million of mortgages. GNMA security holders are protected by the full faith and credit of the United States Government. The stated maturity of a GNMA pool depends on the mortgages that underlie it. During the period with which we are concerned, the coupon or interest rate of the pools in existence varied between 6.5 and 16.5 percent. Most single-family, residential mortgages carry a stated maturity of 30 years.

Although Ginne Mae's are not callable, the underlying mortgages may be prepaid at any time. Due to the prepayment of principal on single family home pools, the average maturity of a pool is considerably less than 30 years. High coupons would pay down faster than low coupons, particularly when interest rates fall. The market practice is to quote Ginnie Mae yields on a pool of such mortgages to a 12-year half-life (i.e., the point in time when the principal amount of the pool is expected to be repaid). FMAC securities or "Freddie Macs" are participation certificates representing an undivided interest in a pool of conventional (non-VA and non-FHA) mortgages, the principal and interest are guaranteed by the Federal Home Loan Mortgage Corporation, a corporation owned by the Federal Government. They also are subject to prepayments. While there are differences in these securities, for our purpose, those differences are not relevant.

The Portfolios

A forward contract is a transaction in which two parties agree to the purchase and sale at a future time, known as the settlement date, of a commodity, financial instrument, or security under the terms negotiated by the parties. Forward contracts are similar in concept to futures contracts; the latter, however, are for short periods of time, contain standardized terms, and are traded on a regulated board of exchange. GNMA and FMAC forward contracts are exempt from registration under the Securities Act of 1933. Forward contracts in these securities were developed because, while the mortgagee was committed to loan the funds, the actual mortgage would not come into existence for 60 or 90 days. During this time, the mortgagee was at risk. Thus the concept originated as a device to "hedge" that risk. There is an active market for forward contracts; however, that market was not designed for individual investors.[4] In the market, forward contracts for 5 or 6 months or longer are rare because of the extreme financial risks involved.

A forward contract to purchase a security, or a "long position," represents an obligation to accept delivery of the underlying security on a specified day. A forward contract to sell a security, or a "short position," represents an obligation to make delivery of the underlying contract on a specified day. An outright or "naked" long or short position involves great risk. The risk in an outright position is that the price of the underlying security will rise or fall.

The simultaneous holding of a long position for one settlement date and a short position for another settlement date constitutes a "straddle." The long and short positions are commonly referred to as the "legs of the straddle." A straddle theoretically enables an investor to close out the loss leg and

[4] An individual trading even a $1.8-million contract is very unusual.

offset the loss recognized against ordinary income or capital gain from another source, while holding the gain leg open until a later year with an offsetting position to protect the unrealized gain. This technique theoretically results in both tax deferral and conversion of ordinary income into long-term capital gain. In a straddle position, the risk is that the spread or the difference between the prices of the two legs will widen or narrow. With respect to the petitioners, First Western dealt only in complete portfolios of straddles in GNMA and FMAC forward contracts.

First Western structured the portfolios such that the short and long legs of the straddle consisted of forward contracts calling for the delivery of underlying securities with different interest rate coupons and different settlement dates. The settlement dates of these contracts were often 18 months and longer. These strategies are called "coupon spreading" and "time spreading," respectively, and they implement several market assumptions. First, the price of fixed income securities is inversely related to the market interest rate. Second, the price of a higher coupon security changes more, for a given change in interest rate, than that of a lower coupon security. This assumption is critical to the First Western theory of coupon spreading. Third, the longer the maturity of a fixed income security, the greater will be its change for a given change in interest rate. Fourth, the larger the portfolio, the larger will be its dollar change in value for any change in the interest rate. These assumptions require that all other market variables remain constant.

Prices

The prices for the GNMA forward contracts in issue were not quoted on an exchange. Rather than consult the primary

dealers for a market price,[5] First Western used computerized pricing algorithms to set prices for the forward contracts involved here. First Western did not quote its prices to market dealers.

Prior to January 14, 1980, First Western used the Telerate[6] quote for the cash price of a GNMA 9.5 coupon to generate cash prices for other GNMA and FMAC coupons. From the Telerate composite quote for the cash price of the GNMA 9.5, First Western calculated the GNMA yield for this security. This step is called a price-to-yield conversion. First Western then calculated various coupon yields by assuming a constant yield spread between any two GNMA or FMAC coupons — always equal to 20 percent of the difference between two GNMA's or two FMAC's and always equal to 0.03 percent as between a FMAC and a GNMA with the same coupon rate.[7] This step is called a yield-to-price conversion.

From these assumed GNMA and FMAC yield numbers, First Western calculated cash prices on which it traded forward contracts. Specifically, First Western calculated the cash price for each GNMA and FMAC coupon that would result in a GNMA yield or FMAC yield already calculated for that coupon.

[5] Dealers determine the market price for forward contracts in Government mortgage-backed securities by calling a number of other deals and asking each to quote a price. Dealers, however, did not make markets in the long-term contracts that First Western wrote.

[6] Telerate, Inc., provides composite quotations of bid and ask prices for GNMA's available for immediate and for delayed delivery. During the years 1978 through 1982, Telerate never quoted prices for GNMA forward contracts with settlement dates more than 6 months in the future. First Western, however, wrote forward contracts with average delivery dates of 14 to 22 months in the future, and it wrote some contracts with delivery dates as far out as 30 months.

[7] Robert Shiffer, one of respondent's experts, testified that only once in 16 years had he observed a 3-day constant yield spread between securities. That case involved a dishonest employee who deliberately programmed the computer to show a constant yield spread between the two securities, and it cost his firm $1.2 million.

First Western used these assumed cash prices as a starting point from which to calculate forward prices. In so doing, First Western assumed a linear relationship between the forward price for each maturity and the cash price. In other words, forward prices for all coupons and maturities precisely tracked the movement in the cash price, which itself depended on the price of the GNMA 9.5.

First Western produced this linear relationship between cash prices and forward prices by using its own cost of carry model which entailed a number of implicit and explicit assumptions. First Western assumed a constant 10.65-percent cost of carry on forward contracts with maturity dates of up to 2 years in the future.[8] Also, First Western implicitly assumed there would be no prepayments in any mortgage pools before the maturity of the forward contract. Since a forward contract specifies delivery of an agreed face amount of a particular GNMA or FMAC coupon, holders of long positions in forward contracts, unlike holders of GNMA or FMAC securities, enjoy protection against prepayment during the life of the forward contract. Thus, forward contracts would be theoretically more valuable than a cost-of-carry calculation assuming no prepayments would predict. This would be especially true for seasoned high-coupon GNMA's or FMAC's and would become increasingly important as interest rates fall.

In sum, prior to January 14, 1980, First Western's pricing formula made several assumptions which reduced the risk that prices of different contracts would move independently. For example, the assumption of a constant yield spread among all coupons eliminated the risk that cash prices for these coupons

[8] In a period of high interest rate volatility, the assumption of a 2-year constant carry rate is arbitrary and simply untenable. During the period in issue the interest rates on 2-year Treasury notes, a comparable default-riskless security ranged from 7.57 percent to 16.48 percent. Similarly, interest rates on 3-month Treasury bills ranged from 6.29 percent to 16.30 percent.

would move independently. Similarly, the assumption of a constant carry rate eliminated the risk that longer maturity forward prices would move independently of shorter maturity contracts due to changes in the prevailing market interest rate. By making these assumptions and by limiting the market data input to the cash price of the GNMA 9.5, First Western insured that its forward contract prices moved in lockstep with the price of the GNMA 9.5, and with each other. As a result First Western's pricing algorithm guaranteed that the two legs of any straddle moved in tandem. Essentially, First Western assumed away all market risk other than movement in the price of the GNMA 9.5

Effective January 14, 1980, First Western unilaterally altered its pricing calculations for purported reasons of "empirical" risk control. The changes implemented were twofold. First, First Western calculated cash prices differently for all coupons, including the GNMA 9.5 benchmark, by adding an "adjustment factor." In other words, First Western took the GNMA 9.5 cash quote from Telerate and added to it an adjustment factor to obtain its own GNMA 9.5 cash price. By adding the adjustment factor, First Western reduced the volatility of its own cash price for the GNMA 9.5 relative to that of the market price for the same security.

Second, First Western changed its cost-of-carry calculation for forward contracts. Previously, First Western calculated the cost of carry using the standard time frame between the current date and the maturity date of the forward contract. After January 14, 1980, however, First Western calculated the cost of carry for the time period between January 14, 1980, and the maturity date.[9] This cost-of-carry calculation is completely

[9] The following example serves to illustrate the impact of this change on First Western prices. Under the original formula, if First Western priced a contract on Jan. 1, 1983, for delivery on Mar. 1, 1983, it would add 2 months' cost of carry to the calculated cash price of the underlying coupon. Under the

arbitrary and is unrelated to any standard financial calculations or analysis.

First Western implemented these pricing modifications after a dramatic increase in the level and volatility of both mortgage interest rates and Treasury bill and note rates. As a practical matter, "empirical risk control" was simply a means by which First Western achieved an even greater degree of control over the pricing of its contracts; first, by substituting a constant for a variable time in the calculation of forward prices from spot prices and, second, by systematically attenuating the effects of market influences on the price of the GNMA 9.5 — the only point of contact between First Western's contracts and the actual market.

The market risks of increased price volatility, increased carry rates, and independent price movement cause true issuers of forward contracts in fixed income securities to limit the size of the positions they allow their customers to take. Avoiding market prices and their inherent risk enabled First Western to structure straddle portfolios with uncommonly large positions. As a result, First Western offered its clients enormous tax benefits compared to their "margin" deposits and without increasing its own risk of loss.

Settlements

Settlement of forward contracts is predicated on the assumption that delivery of the underlying security will be made.[10]

Whether or not actual delivery takes place, the effective possibility of actual delivery, combined with the possibility of entering into individual contracts, gives economic reality to forward and futures markets for financial instruments. The

new formula, using the same example, First Western would add over 3 years' cost of carry to the adjusted cash price.

[10] Dealers customarily execute every trade with the intent to deliver.

effective possibility of delivery links the forward or futures market to the underlying cash market because the forward or futures price must nearly converge with the cash price of the underlying financial instrument as the maturity of the forward or futures contract approaches. Otherwise, arbitragers could make riskless profits by taking opposite positions in the forward market and the cash market and closing out the position by going to actual delivery.[11]

The other general method of settlement of a futures contract is "setoff." This occurs when the parties enter into an opposite contract for the same security and agree to offset or pair off the liabilities of both contracts. On settlement, the difference in the prices of the two contracts is paid in cash.

In First Western's program, physical delivery, the actual transfer of the underlying instrument, did not occur.[12] Indeed, First Western's computer program contained no provision for delivery.

First Western used two additional methods of settling contracts that, while having their genesis in the jargon of financial transactions, were used in a fashion far different from that generally contemplated. Generally, cancellation is used, as its name suggests, to rescind or cancel a transaction in case of an error or where there is a substitution of contracts. First Western and its customers, however, used cancellation in situ-

[11] For example, if the forward price exceeds the cash price at the maturity of a forward contract, arbitragers will buy the instrument in the cash market at the lower price and sell it in the forward market at the higher price, thus making a riskless profit.

[12] There are several reasons why First Western clients avoided delivery. One explanation is that the clients would have been financially incapable of making or taking delivery (due to the size of the positions in their portfolios). Also, clients always held entire portfolios rather than individual contracts. Since the two sides of the portfolio were similar in size, if a client went to delivery on contracts on one side of the portfolio, First Western might go to delivery on contracts on the other side of the portfolio and thereby decrease the client's net gain.

ations where there were no errors or substitutions. Rather, "cancellation" was used because theoretically it resulted in ordinary gain or loss for want of a sale or exchange.

The second unorthodox method of closing transactions was by assignment. Again, an assignment of a contact has a place in the financial markets. It is used to effect delivery of a security to a third party to whom the purchaser is obligated. First Western, however, used assignments as a substitute for sales necessary to achieve a capital gain or loss. First Western controlled whether a client could assign or cancel a contract. First Western charged fees for cancellations and assignments.

First Western's use of these latter methods of settlement was solely for tax purposes. Legs of straddles with losses generally would be canceled. The gain legs generally would be assigned. In these cases, the assignors' (petitioners') accounts with First Western were credited with approximately 99 percent of the net "value" of the contract. The assignments in these cases were to Benson Financial (Benson), Ionian Financial Ltd. (Ionian), or National Mortgage Corp. of America (National Mortgage).

The settlement by First Western of the contracts "assigned" to Benson, Ionian, and National Mortgage was peculiar. The contracts provided that "The coupon rate specified above is the only coupon that may be delivered." It does not appear, however, that any of the assignees ever demanded delivery. Rather, the accounts were apparently settled for cash, whereby the assignees received approximately 1 percent of the value of the contract at the time the contracts were assigned. That value was determined by First Western's pricing. In the case of petitioner Harby, for example, First Western's records showed that he assigned contracts to National Mortgage having a net value of $143,523 on March 3, 1982. The assignment, however, was dated March 23, 1982, and bears a "received" stamp of May 19, 1982. The contracts that were assigned had

expiration dates of March 7, 1982, and May 19, 1982. First Western's "Schedule of Assignment Fees" lists $1,450 as the amount "due" National Mortgage from the assignment. National Mortgage's account with First Western shows that the assigned contracts were put into National Mortgage's account with First Western where they immediately were "canceled" or "set off" with debits to its margin account and credits to the assignors' accounts. Thus, there was absolutely no risk to the assignee, the assignor, or First Western.

The assignments to Benson and Ionian were similar. In total, by May 31, 1983, Benson received assignments having a value of $22.8 million, Ionian $298.3 million, and National Mortgage $117.8 million. While the exact amount that National Mortgage received is unclear, Benson received $228,019 and Ionian $1.3 million from First Western.

Margins and Fees

A margin is a good-faith deposit made by a trader with a dealer and is not a downpayment on the security. In the marketplace, the customer's margin neither limits his potential liability nor bears any relationship to tax considerations. The First Western program, however, based margin requirements on the client's "tax preference" (viz., the requested amount of tax loss to be realized in a given year). Furthermore, First Western limited its customers' potential monetary loss to their initial margin.

For an over-the-counter market maker, fees are generally a function of price. A dealer, for example, will "mark up" the price of the security in its "ask" price. First Western's fees, in contrast, were merely a function of the customers' "tax preference." On First Western's books, the fees were immediately "budgeted" out of the "margin," and a fee cap was established. The budgeted fees were ranged between 40 to 70 percent

of the margin,[13] or 7 to 8 percent of the tax preference. Thereafter, fees were charged against the account on the various transactions until the budgeted fees were satisfied.

Hedging

Actual dealers in securities of this nature use hedging to limit their risks. A perfectly hedged dealer would be in balance — i.e., it would be short the same amount of contracts as it would be long. This would be desirable in times of market volatility. First Western maintained an account with Conti Commodity (Conti) that it claimed was a hedging account for purchasing futures of GNMA's. While First Western may have maintained an account with Conti, its daily hedging reports show extremely large exposures, particularly in view of the prevailing interest rate volatility and First Western's limited capital. These reports reveal that First Western was routinely exposed to the extent of many times its net worth. First Western's balance sheets that are in the record showed the following equity:

Date	*Amount*
Dec. 31, 1979	$3,413,000
Mar. 31, 1980	2,615,000
Mar. 31, 1981	17,937,000
Mar. 31, 1982	[14]6,339,000

The following is a limited list of First Western's exposure on certain dates:

[13] In other words, because First Western took approximately 50 percent of the margin deposit as its fee, the client had to double his investment before he could make a profit.

[14] At some time between Jan. 1 and Mar. 31, 1982, all the outstanding stock of First Western was transferred from Sidney Samuels to First Western Investments, Inc., and a $20 million dividend was paid.

Date	*Amount*
Nov. 11, 1980	$30,4 million
Jan. 23, 1981	53.2 million
Mar. 24, 1981	48.9 million
Apr. 14, 1981	[15]1.1 billion
June 25, 1981	26.0 million

For substantial periods of time, the number of futures contracts that were the predicate for the hedging program remained constant. Furthermore, at least on one occasion First Western was hedged the wrong way — its risk was on the short side and its "hedging" account was also short.

First Western, however, had other methods of controlling risk. When a leg was "canceled" another leg with contracts of similar coupons and time lengths to those in the open leg would be purchased or sold short. Since the pricing algorithms essentially guaranteed that the values of the contracts would move in lockstep, the account was, in First Western's terminology, "neutralized."

B. *Finders and Customers*

While there were nine test-case petitioners,[16] we find it unnecessary to delve into the minutiae of the transactions between each petitioner and First Western. Rather, it seems to us more relevant to highlight the relationship as reflected by the general business dealings between First Western and its customers. In

[15] This was claimed to be a statistical "glitch." But if, as Mr. Samuels and Mr. Bender testified, these reports were reviewed daily, it is difficult to see how such a glitch would not have been spotted immediately and corrected. If it were a glitch, that omission from that data would not alter our overall view on the propriety of the hedging program.

[16] Originally there were 10 test cases. Wilhide, however, was severed. The remaining petitioners have agreed to be bound by the record containing facts relevant to Wilhide as they relate to First Western's program.

this regard, we note that, while the transactions of the test case petitioners with First Western may be typical, the individual petitioners are not typical because of the non-random selection process of the test cases. Petitioners chose five cases, and respondent chose five cases. Understandably, both sides chose cases that were more favorable to their respective views of the First Western transactions. For example, four of the nine test-case petitioners had profits; in First Western's program, however, approximately 3 percent of its customers had profits from trading its forward contracts, and of this latter number, First Western employees showed substantial profits, with Mr. Samuels leading the pack. Nevertheless, somewhat of a pattern does emerge from the test cases.

First Western did not advertise. Rather, its program was spread by word of mouth among accountants, lawyers, and financial consultants — the "finders."[17] Finders were paid by First Western — the remuneration was based upon a percentage of the margin and tax preference. In some cases, the finders also charged their clients. Typically, a finder or customer would obtain a package from First Western. In cases where "finders" were involved, at least as far as the test cases reveal, the customer had little or no understanding of the program.

Womble

Petitioner Womble is a physician.[18] During the last quarter of 1980, he contacted Robert Taylor, an attorney in Dallas,

[17] As noted before, originally Samuels & Co. (later Samuels, Kramer & Co.) and First Western had different functions. Samuels & Co. designed the portfolio and First Western executed the "trades." Later the former function was absorbed into First Western; there is not, however, any substantive difference in the two methods of operations. Accordingly, for simplicity we omit the role played by Samuels & Co. from our discussion.

[18] Dr. Womble's transactions with First Western were conducted through a partnership (Investadox) of which he was the administrative partner. During

Texas. Taylor had written a "Confidential Memorandum to Interested Clients" in which he outlined "the best potential tax shelter investment I have reviewed in the last ten years." The memorandum noted "an investor would show a tax loss of eight to one [and], [i]f the investment is successful the investor may receive a cash profit along with a tax loss — an infinite ratio,"[19] Robert Taylor subsequently wrote to Dr. Womble:

> Shortly before the money went in for this partnership investment, First Western Securities decided to allocate a slightly higher amount of the investment to the margin account itself. The reason for this is to give flexibility for additional trades to generate gains and protect the investment from attack by the Revenue Service on the ground that there is no profit motive.
>
> The net result will be that the total amount of losses generated for 1980 will be slightly less than the $300,000 contemplated, but not enough to make very much difference. By the time the trading is completed for this year, my guess is the total loss available will be in the $280,000 to $290,000 range. Every $7,000 invested should still receive losses in the neighborhood of $46,000 to $49,000 for the year, depending upon the results of the trading.

Dr. Womble executed the standard First Western documents — an interest rate forecast, a standard customer's agreement, and a new account application. The customer's agreement pro-

the trial, the parties have essentially ignored the partnership entity and, for the purposes of this discussion, we do the same.

[19] Petitioners assert that respondent cannot attribute this statement to First Western. Perhaps not, but the statement is clearly indicative of the perception of the program that many participants shared.

vided, inter alia, that First Western "may without demand for margin, whenever in [its] discretion [it] deem[s] advisable for my or [its] protection, sell any or all securities held in any of my accounts * * *, and [it] may borrow or buy in any securities required to make delivery against any sale effected for me * * *. Such sale or purchase may be public or private and may be without * * * notice to me and in such manner as * * * [it] in * * * [its] discretion may determine." These documents were forwarded to A. F. Campbell & Co. (a finder) with checks totaling $42,000. Campbell then sent the package including a "tax data" statement to First Western's office in San Francisco. The "tax data" statement requested an ordinary loss for 1980 in the amount of $280,000 and a long-term capital gain for the year 1982 in the amount of $280,000. The San Francisco office generally put this information in its computer, aggregated all requests received that day, and sent them by a "night letter" [20] to the New York office. Portfolios of straddle positions were then constructed by a computer, the prices set by the algorithm discussed above. On November 26, 1980, First Western transmitted the proposed portfolio to Dr. Womble. This communication provided that "[u]nless you advihe [*sic*] us otherwise by 1:00 PM EST on November 28, 1980, we will execute the required trades at the prices current on that date." [21] The portfolio provided:

Action	*Issue*	*Settlement date*	*Face value*
Sell short	GNMA 9.00%	3/17/82	$8,500,000
Sell short	GNMA 11.00	3/17/82	7,500,000
Buy	GNMA 10.00	6/16/82	8,500,000
Buy	GNMA 8.00	6/16/82	7,600,000

Dr. Womble received confirmations dated November 28, 1980, showing the price of each coupon. On December 9, 1980, Dr. Womble received the following confirmations:

Sell short	GNMA 11.00%	3/17/82	$600,000
Buy	GNMA 8.00	6/16/82	9,900,000

On December 11, 1980, the following transactions were confirmed:

Short sale	GNMA 11.00%	3/17/82	$800,000
Buy	GNMA 8.00	6/16/82	900,000

On December 15, 1980, the following transactions were confirmed:

Buy	GNMA 9.50%	10/20/82	$3,800,000
Buy	GNMA 8.50	10/20/82	3,300,000
Buy	GNMA 9.50	9/15/82	3,200,000
Short sale	GNMA 9.00	3/17/82	1,200,000
Canceled	GNMA 8.00%	6/16/82	9,900,000

On January 22, 1981, the following transactions were confirmed:

Buy	GNMA 10.00%	10/20/82	$4,600,000
Sell short	GNMA 11.50	5/19/82	1,200,000
Buy	GNMA 8.50	10/20/82	1,000,000
Canceled	GNMA 8.00	6/16/82	7,600,000
Canceled	GNMA 11.00	3/17/82	600,000
Canceled	GNMA 11.00	3/17/82	800,000
Canceled	GNMA 9.00	3/17/82	1,200,000

On February 2, 1981, Campbell sent to First Western another tax data sheet requesting an ordinary loss of $131,000 for 1981 and a capital gain of $131,500 for 1983. Three days later, First Western sent a letter to Dr. Womble requesting an additional "margin" of $16,900 within 5 days. This letter was rescinded on February 18, 1981.

The trading process repeated itself with various purchases, short sales, and cancellations. On December 7, 1981, First Western wrote a letter requesting an additional $12,000 margin

by December 17, 1981. For 1980 and 1981, First Western's transactions resulted in losses in the amounts of $284,744 and $131,682, respectively. On February 2, 1982, First Western wrote to Dr. Womble informing him that he had forward contracts coming due during that year. First Western records show that the contracts were assigned to National Mortgage on February 26, 1982. Dr. Womble assigned those contracts to National Mortgage for approximately 99 percent of their net value. Some of the contracts assigned had settlement dates expiring over a year later. On April 6, 1982, Dr. Womble received a check in the amount of $6,117 from First Western closing out the account. Dr. Womble's out-of-pocket loss was approximately $48,000, not considering the purported tax benefits he received.

While Dr. Womble had some financial experience, it is obvious that he had very little understanding of First Western's program. He did not know that First Western made the market in these securities. He believed he could check First Western's prices by looking in the Wall Street Journal, but he never did. He had no knowledge of First Western's fee structure. He never attempted to verify whether his interest rate forecast was, in fact, correct. He had predicted that interest rates would go up and never changed that forecast. In May 1981, however, First Western changed his forecast, and Dr. Womble was not aware of the change. We find this somewhat bemusing because, while there were peaks and valleys, interest rates generally did increase during this period. When questioned about the initial proposed portfolio, he responded: "I bought Ginnie Maes at 10 and at 8 * * * [a]nd I sold at 9 and 11." This apparently refers to the coupon of the contract, and clearly indicates that he had no understanding of that portfolio.

Lewis

Petitioner Lewis is an engineer. He was introduced to First Western by Marvin Neese whom he had known for only 3 or 4 months. Mr. Lewis had no knowledge of Mr. Neese's financial expertise except that he managed other First Western accounts. Nonetheless, he simply turned the account over to Mr. Neese. Mr. Lewis never understood the portfolio selection, never checked prices, did not know what a mortgage-backed security was, did not know that there was no market for mortgage-backed forward contracts for delivery in 14 to 22 months, and did not know the difference between a future and a forward contract. Mr. Lewis invested $5,000 in First Western's program. First Western first informed Mr. Lewis of the trades it had devised to implement his interest rate forecast by letter dated August 29, 1979, even though it executed trades for him on August 6, 1979. The account records show that he (or Mr. Neese) requested a $50,000 loss for 1979 and a $35,000 loss for 1980. Among other deductions and losses related to First Western, he claimed ordinary losses of $49,305 for 1979, and $37,768 for 1980. On April 28, 1982, First Western credited Mr. Lewis's account with $9,463 from National Mortgage, for contracts that had been "assigned," even though Mr. Lewis did not assign the contracts until June 4, 1982. Mr. Lewis's situation is exceptional in that he took out more money than he put in.

Harby

Another successful player in the First Western program was petitioner Harby, a retired Army officer who also relied on Mr. Neese. Col. Harby had no knowledge of the fee structure, he was "embarrassingly naive about this program," he had little knowledge of mortgage-backed securities, did not know

that there was no market for 14- to 22-month forward contracts, did not understand the difference between offset and cancellation, and did not know the difference between future and forward contracts.

For 1979, First Western was requested to produce a $50,000 loss, and Col. Harby claimed a deduction in the amount of $54,777. For 1980, a total loss of $68,500 was requested, and a $76,624 loss was claimed. For 1981, a $50,000 loss was requested and a $33,798 loss was claimed. There is, however, one aspect of Col. Harby's account that is noteworthy. On November 19, 1980, First Western canceled a contract in which Col. Harby had a $30,450 profit. Col. Harby wrote to First Western on January 16, 1981, eight weeks later, and in the subsequent tax year, and requested that the contract be "reinstated" because the cancellation had not been "authorized" by him. We find it peculiar that an investor, allegedly seeking a profit, would seek to eradicate a $30,000 profit. Nonetheless, and notwithstanding the provisions of the agreement with First Western giving First Western the authority to trade, First Western reinstated the contract. The contracts in Col. Harby's account were assigned to National Mortgage on March 3 and May 7, 1982, and credits were made to his account. Col. Harby did not execute the assignment forms, however, until March 23 and July 6, 1982.

Poulos

Dr. Poulos is a surgeon who was introduced to First Western by Robert Schmidt. Mr. Schmidt is an "estate planner" operating through "Interplan, Inc." Dr. Poulos "really didn't understand" First Western's program and relied on Mr. Schmidt. Mr. Schmidt received payments from both First Western and Dr. Poulos for his services. In 1978, Dr. Poulos paid $15,000 to First Western and requested a $150,000 ordinary loss. He

claimed a loss of $152,359 on his 1978 tax return. Dr. Poulos did not receive confirmations for the 1978 trades made in November and December until April 13, 1979. For 1979, Dr. Poulos paid to First Western $27,500[22] and on September 26, 1979, requested an ordinary loss of $175,000 and a short-term capital loss of $100,000.[23] On his return for that year, he deducted a $183,416 ordinary loss and reported $39,671 as a net short-term capital gain. For 1980, Dr. Poulos paid to First Western $19,500, and requested a $150,000 ordinary loss. Dr. Poulos reported on his 1980 return a short-term capital gain of $241,380, a short-term loss of $209,720, and an ordinary loss of $167,244. By an assignment dated March 1, 1982, Dr. Poulos assigned the contracts in his account to Ionian, and his account was credited with $413,586. Dr. Poulos lost money if no consideration is given to the tax deductions. In addition, Dr. Poulos paid Mr. Schmidt (through Interplan, Inc.) $7,500 in both 1978 and 1980 and deducted these amounts on his tax return. He paid Mr. Schmidt (again through Interplan) $10,750 in 1979 and claimed a deduction in the amount of $12,500. There is no basis in this record for determining what portions of these fees were for services other than those connected with First Western's program.

Timm

Mr. Timm is a geologist and was also introduced to First Western by Mr. Schmidt. Like Dr. Poulos, Mr. Timm did not understand the First Western program and relied on Mr. Schmidt. For 1978, Mr. Timm paid $5,000 to First Western,

[22] An additional $2,250 was transferred to First Western from Dr. Poulos' account with Conti.

[23] Dr. Poulos realized a $144,858 gain on Mar. 26, 1979, and reported that gain on his return. His transactions with First Western after Sept. 26, 1979, resulted in a short-term capital loss of $105,188.

and Mr. Schmidt requested a $50,000 ordinary loss. On his 1978 return, Mr. Timm claimed an ordinary loss in the amount of $50,476. He also deducted $2,500 as "investment counsel fees," apparently for services rendered by Schmidt. As with Dr. Poulos, Mr. Timm did not receive confirmations for 1978 First Western transactions until April 13, 1979. After the 1978 year, Mr. Schmidt wrote to Mr. Timm:

> We reduced the risk of trading government securities by entering into a spread technique with those instruments used in the forward (over-the-counter) market. We leveraged (traded large purchases on a small margin) your investment to purchase instruments with a total face value of $4 million. By canceling one-half of the forward contracts on December 28th, you sustained a $50,476 ordinary loss. To complete the hedging technique, the remaining forward contracts sold in 1979 have resulted in a short term capital gain of $49,536. This loss reduced your 1978 income taxes by (an estimated) $17,600. When deducting the cost of your investment of $4,440 from your tax savings, your estate has increased by approximately $13,225. This equates out to a 298% net capital return in six months. The interest return, when properly reported on an annual basis, would be 595%.

In July 1979, Mr. Timm sent First Western another $5,000. Mr. Schmidt wrote to Mr. Timm, on July 23, 1979, that he "cannot complete your tax shelter until all fees are paid." The letter concluded "my limited time can only be spent with clients who are willing to pay for services rendered." Mr. Timm sent Schmidt a check of $1,000 and Schmidt submitted a tax data sheet on September 24, 1979, requesting a $50,000 short-term

capital loss (to offset the 1979 gain from the 1978 program) to be rolled into a long-term gain in 1981. For transactions with First Western, Timm deducted a short-term capital loss in the amount of $58,669.[24] Mr. Timm did not receive confirmations of trades made in March 1979, until June 1979.

On June 24, 1980, Schmidt requested a $60,000 ordinary loss and a $75,000 short-term capital loss for 1980. On his 1980 return, Mr. Timm claimed a $62,004 ordinary loss and a net $77,611 short-term capital loss. Mr. Timm paid to First Western $17,550 in 1980. He also deducted $844 as "First Western Gov-Sec-Counsel" and $6,750 as "investment council [*sic*]." For 1981, Mr. Timm paid to First Western $8,500, requested an $85,000 ordinary loss, and claimed an ordinary loss of $84,523. First Western's records show that Mr. Timm assigned his First Western contracts to National Mortgage on March 10, 1982. Mr. Timm did not execute the assignment contract until March 25, 1982. Mr. Timm loss money in his dealing with First Western.

Ames

Petitioner Ames was introduced to First Western by John Burns and was a successful participant in First Western's program. As with Messrs. Timm, Womble, Lewis, Harby, and Poulos, Mr. Ames' knowledge of First Western's program was, at best, sketchy, and he relied on Mr. Burns. On November 20 and 27, 1979, Mr. Ames paid a total of $260,000 to First Western and requested a $2 million ordinary loss to be converted into a long-term capital gain in 1981. Mr. Ames understood that his losses would be limited to his $260,000

[24] He also reported a short-term capital gain for transactions before that date in the amount of $46,036.

margin deposit,[25] for otherwise there "would have been a real exposure" and he "would have [had] a real problem." On his 1979 return, Mr. Ames deducted an ordinary loss of $2,029,934 and a $2,000 deduction for an investment advisory fee to Samuels-Kramer. For the year 1980, there is no record of any correspondence from Messrs. Ames or Burns to First Western. Notwithstanding this, transactions with First Western continued in which Ames received losses.

For the taxable years 1980 through 1983, the following net transactions were reported on the tax return:

Stipulation No.	*Amount*	*Type*
1980		
849	$9,422,948	Ordinary income
865	(10,218,545)	Ordinary loss
878	697,994	Ordinary income
880	(22,092)	Ordinary loss
886	(26,700)	Ordinary loss
Total	(146,395)	Ordinary loss
1981		
898	566,331	Ordinary income
901	(571,418)	Ordinary loss
905	(422,647)	Ordinary loss
Total	(427,734)	Ordinary loss
1982		
920	722,707	Long-term capital gain
928	(307,245)	Long-term capital loss
Total	415,462	Long-term capital gain
1983		
935	5,602,206	Long-term capital gain
935	(3,294,181)	Short-term capital loss
Total	2,308,025	Long-term capital gain

[25] A letter from Sidney Samuels to a Dr. Redy, a non-test case First Western customer, makes it clear that First Western's policy was to limit losses to the client's margin deposit. "To summarize, the *maximum* cash loss you will sustain in the combined First Western Government Securities, Inc./Conti Commodity Services, Inc. program is $5,000 in 1978 and $5,000 in 1979. Samuels & Co. and First Western Government Securities, Inc. will hold you harmless for any losses in excess of the above."

On February 26, 1982, Mr. Ames executed an "assignment" of various First Western contracts, having settlement dates of March 26, 1982, to Ionian and his account was credited with $726,376 from Ionian. This transaction was somewhat shrouded by the paperwork. There is nothing in the record to indicate that First Western "approved" the assignment at the time. On November 12, 1982, Ionian wrote to First Western that some assignors had not completed their paperwork. First Western sent a copy of this letter to Mr. Ames and requested that he execute the completed assignments. The assignment forms were sent on December 12, 1982, to Mr. Burns. On the same date, however, First Western wrote to Mr. Ames acknowledging assignments under the same terms as the February 26th, assignment.

Wilhide Corp.

Wilhide Corp. (Wilhide) is engaged in designing and furnishing offices. Wilhide is on a fiscal tax year ending February 28. In February 1980, Wilhide, by its president, Conrad Keado, paid First Western $81,250. Wilhide requested an ordinary loss in the amount of $625,000. On February 13, 1980, Wilhide purchased from and sold short to First Western various forward contracts for GNMAs among which were:

Purchase	GNMA 9.50%	6/17/81	$7,700,000
Purchase	GNMA 8.25	6/17/81	6,800,000

On February 19, 1980, these contracts were canceled with a loss of $676,685 that Wilhide deducted on its fiscal year tax return. After the close of its taxable year, there was no record of any correspondence between Wilhide and First Western during its 1981 fiscal year. On March 6, 1980, Wilhide had other purchase and short sale transactions with First Western with settlement dates after February 28, 1981. On March 3, 1981, Wilhide purchased $11,400,000 GNMA 11 percent, settlement 9/15/82, and sold $1,200,000 GNMA 10 percent, settlement date 4/21/82. The same day various contracts expiring in 1981 were "canceled" with a resulting gain in the amount of $23,619. These later transactions were "voided" on March 13, 1981. That same day, another group of contracts, including some contracts canceled on March 3, 1981, were canceled with a resulting loss of $441,570 that was deducted on Wilhide's 1982 tax return. On March 16, 1981, Wilhide assigned contracts to National Mortgage with a resulting gain of $1,042,841 that was reported as a long-term capital gain. National Mortgage sent Wilhide a check for $1,042,841. Wilhide endorsed this check to First Western. First Western wrote a check to National on March 18, 1982, for $1,049,677. First Western's records indicate that $6,836 was due National Mortgage. Wilhide never changed its original interest rate forecast because "we did not follow the program as we should have."

Freytag

Mr. Freytag is a lawyer who specializes in tax aspects of real estate transactions. Mr. Freytag, and at least one of his partners, decided to invest in First Western's program. Mr. Freytag's law firm became a "finder" and introduced at least 18 clients to First Western and was paid approximately $120,000 by First Western. The fees with respect to Mr. Freytag's account were not reported by the firm but applied to the account

expenses, and the firm gave the balance to Mr. Freytag. Mr. Freytag did not reduce the amount of his losses or otherwise report these amounts.

The record does not reveal the amount of loss requested in 1978. For later years, Mr. Freytag, or his agent, requested the following:

	Short-term capital loss	*Ordinary loss*
1979	$70,000	$100,000
1980		100,000
1981		130,000
1982		140,000

The ordinary losses were to be converted into long-term capital gains in subsequent years. Mr. Freytag reported on his tax returns the following:

	Short-term capital loss	*Ordinary loss*
1978		$70,539
1979	[26]$112,308	99,403
1980	[27]3,000	101,794
1981		[28]162,216
1982		143,001

Mr. Freytag sent First Western checks as follows:

Nov. 3, 1978	[29]$7,000
Oct. 12, 1979	[30]11,500
Oct. 21, 1980	10,000
Feb. 18, 1981	30,000
Apr. 2, 1982	10,000
June 22, 1982	10,000

[26] Used to offset gain of $106,005.

[27] Carried over from 1979 from First Western transactions.

[28] Mr. Freytag claimed an ordinary loss in the amount of $126,188.

[29] There were two checks — one payable to First Western for $2,000 and another payable to ContiCommodity for $5,000.

[30] $4,174 was also transferred from Conti/Commodity.

Mr. Freytag's account with First Western is noteworthy in that his account frequently showed a deficit balance — i.e., Mr. Freytag owed First Western substantial amounts of money. While First Western sent letters requesting additional funds or "margin," Mr. Freytag never satisfied these requests. Nonetheless, First Western did not close his account nor did it close his positions. Indeed, First Western allowed Mr. Freytag to increase his risk to $15,000 per point, when he had a negative account value of $35,864, and to $25,000 per point, when he had a negative account value of $97,117. A letter written by Mr. Freytag to First Western, apparently in 1978, explains:

> You agree with the undersigned that the grant power [of attorney] creates the duty on your part to liquidate the account of the undersigned whenever market conditions threaten losses in excess of the margin deposits in those accounts. In the event of market conditions adverse to the positions taken by me, you hereby assume the responsibility of liquidating my account prior to the accrual of losses in excess of the amounts of margin I may elect from time to time to deposit with you, plus the amounts of gains then accrued to the open positions in my account; any losses in excess of such total shall be solely your responsibility * * * .
>
> If the foregoing correctly sets forth your understanding * * * please indicate such by executing the enclosed copy * * *

The understanding was accepted by Sidney Samuels on behalf of First Western.[31]

[31] Compare Mr. Freytag's testimony:

QUESTION: At the time you invested in the 1978 program that the most you could lose would be the amount of cash you put up?

ANSWER: [Mr. Freytag]: So that the margin was the limitation on my losses?
QUESTION: Right.
ANSWER: No.

Mr. Freytag explained that he viewed his 1978 letter as "a stop loss order." That letter, however, was explicit — "any losses in excess of * * * [the margin plus gains] shall be solely your responsibility."

Maule

Mr. Maule is an officer and principal owner of a furniture manufacturing company. Mr. Maule was introduced to the First Western program by Dave Kobsev, about whom he knew virtually nothing. He understood that a $100,000 loss could be realized in 1980, the account would be "neutralized" in 1980 — i.e. "I would not be at risk," and a capital gain would be reported in 1982. In Mr. Kobsev's presentation of a "worst case" situation involving First Western transactions, there was no indication that Mr. Maule could lose more than his original margin, and Mr. Maule believed that his potential loss was so limited.

For the taxable year 1980, Mr. Maule requested a $100,000 ordinary loss. On June 23 and 27, 1980, a series of forward contract transactions were entered into that culminated in one $4,200,000 contract being canceled with a $117,642 loss. That loss was deducted on Mr. Maule's 1980 return. On July 7, 1980, two weeks after the initial transactions, First Western deposited a check from Mr. Maule in the amount of $13,000.

In 1981, a request was made for a loss of $100,000. Mr. Maule's statement showed that the value of his account on February 27, 1981, was $5,719. Nonetheless, by letter dated March 2, 1981, First Western wrote to Mr. Maule advising that "your account requires an additional margin of $7,300. Please send us a check for the above amount by June 1, 1981." By a series of forward contract transactions, on March 3, 1981, Mr. Maule's account showed a loss of $106,848 by cancellations that Mr. Maule deducted as an ordinary loss on his 1981

return. First Western records show that the account was "neutralized" on March 23, 1981. On April 30, 1981, the account had a value of $3,721. On May 13, 1981, First Western wrote a virtually identical letter to the March 3 letter requiring a $7,300 "margin" deposit. On May 28, 1981, First Western received a check for $7,300. Mr. Maule admitted that when the facts are examined "In retrospect, it very well could have been" that the margin call was for the 1981 tax "writeoff."

McCoin

Mr. McCoin is an investment banker who, through three entities, as involved with the First Western program. McCoin owned a 50-percent interest in Mosher, McCoin & Sims (Mosher), a joint venture that has the attributes of a partnership for tax purposes. Mosher entered into a customer's agreement with First Western in June 1980. First Western's records show that a request was made for a $100,000 ordinary loss in 1980 and a $100,000 long-term capital gain for 1982. On June 24, 1980, First Western established a straddle in First Western's GNMA forward contracts for Mosher. On June 27, 1980, contracts were canceled with a loss of $102,272. On July 11, 1980, First Western received an "interest forecast" and a check for $10,000. McCoin deducted his aliquot part of this loss on his 1980 return.

In 1982, after other transactions in 1980 and 1981, Mosher "assigned" its remaining contracts to Ionian. By letter dated March 25, 1982, First Western acknowledged Mosher's assignment request as of March 10, 1982, and requested that Mosher execute and return an assignment agreement. Apparently, Mosher failed to execute the agreement and, on September 13, 1982, First Western wrote to Mosher and again requested an executed assignment agreement. A form assignment, dated March 10, 1982, was executed at some point in time by which

Mosher "assigned" its remaining contracts to Ionian. Mosher had a $90,822 profit on the assignment, and McCoin reported a long-term capital gain on his 1982 return.

McCoin, however, had two other contacts with First Western. First, he was a partner in Money Managers Joint Venture (MM). MM was formed on November 20, 1980. On December 2, 1980, MM entered into an agreement with First Western. First Western received a request for an ordinary loss of $523,000 for 1980, and a $523,000 long-term capital gain in 1982. On December 10, 1980, MM entered into a straddle of First Western's forward contracts for GNMA's. On December 11, 1980, contracts were canceled with a loss of $388,674. Also, on that date, First Western received checks in the amount of $40,500. One check for $9[illegible]0 was returned for insufficient funds. The amounts of these checks correspond generally to the contributions of capital in MM required by the agreement. Before December 31, 1980, First Western received an additional $44,750 in checks — one of which for $3,000 was returned for insufficient funds. The checks that were returned apparently were never made good. Again these checks correspond to the agreed capital contributions in the partnership agreement. McCoin deducted $59,706, his aliquot share of MM's loss, on his 1980 tax return. Another series of First Western forward contracts transactions culminated in a net loss of $141,979, and McCoin deducted a net loss of $16,759 on his 1980 return. MM's total payment, after allowance for returned checks, was $73,250, and the total "trading" loss was $530,653. For the year 1981, MM requested an ordinary loss of $260,000 with a long-term capital gain in 1983 in the same amount. MM recognized a loss of $268,713 from cancellations in 1981, and McCoin deducted his share of the loss. In 1982, MM "assigned" contracts to Ionian on March 10, 1982, and its First Western account was credited with $801,719. By letter dated March 25, 1983, First Western advised MM that its gain

was $609,047, and McCoin reported a long-term capital gain of $94,631. He also reported an ordinary loss of $4,634 and ordinary income of $199.

McCoin's other connection with First Western was Mosher, McCoin & Sims, Inc. (the corporation), of which he is an owner and an employee. The corporation holds itself out as an "independent investment advisor under the provisions of section 203 of the Investment Advisors Act of 1940." During the years in question, the corporation was paid around $600,000 by First Western for putting its customers in First Western programs. The corporation prepared various presentations of the First Western program for its customers in which it was pointed out that, even if the customer lost his entire margin, he would make a profit from tax savings. The following statement was made by the corporation: "Cash deposit 17% of writeoff should expect to lose all of cash deposit any profit left at end of transaction is 'gravy.'" There is no mention in any of the corporation's materials that a customer could lose more than his payments to First Western. Mosher, McCoin and Sims had reviewed a pamphlet prepared apparently in 1978 by First Western (Samuels & Co.) that provided, inter alia:

> One time margin equal to 10% of the tax writeoff***
>
> * * * * *
>
> No other cash or margin deposits are required.
>
> * * * * *
>
> If customer is correct in his interest rate direction, he will receive a check from First Western in an amount of up to 60% of his initial margin * * *. Note that the tax write-off could be as high as 25 to 1.

ULTIMATE CONCLUSIONS OF FACT

(1) The transactions between First Western and its customers were illusory and fictitious and not bona fide transactions.

(2) Even if the transactions were bona fide transactions, the transactions were entered into primarily, if not solely, for tax-avoidance purposes.

(3) Petitioners claiming deductions based on these transactions are liable for additions to tax under section 6653(a).

OPINION

1. *The transactions were not bona fide.*

Section 165(a) allows deductions for "any loss sustained during the taxable year and not compensated for by insurance or otherwise." Deductions, in the case of an individual taxpayer, are limited, inter alia, to "loss[es] incurred in any transaction entered into for profit, though not connected with a trade or business." The regulations provide that "To be allowable as a deduction * * *, a loss must be evidenced by a closed and completed transaction * * *. Only a bona fide loss is allowable. Substance and not mere form shall govern in determining a deductible loss." Sec. 1.165-1(b), Income Tax Regs.

In examining the tax aspects of straddles of futures or forward contracts for commodities or for financial instruments, this Court has observed two situations. In those cases where the transactions take place on regulated markets, our attention has focused on the profit motive of the participant. E.g., *Smith v. Commissioner*, 78 T.C. 350, 390-394 (1982), affd. without published opinion 820 F.2d 1220 (4th Cir. 1987); *Fox v. Commissioner*, 82 T.C. 1001 (1984). On the other hand, where the market is limited to transactions between the straddle customers an the maker of that market, referred to herein as "off mar-

ket,"[12] we have focused first on whether the purported transactions existed in substance and were not merely a paper trail for tax deductions. E.g., *Forseth v. Commissioner*, 85 T.C. 127 (1985), affd. 808 F.2d 1219 (6th Cir. 1987), affd. 810 F.2d 197 (5th Cir. 1987), affd. 813 F.2d 293 (9th Cir. 1987), affd. 800 F.2d 266 (11th Cir. 1986); *Brown v. Commissioner*, 85 T.C. 968 (1985), on appeal (9th Cir., Jan. 5, 1987, and Mar. 23, 1987). This latter question is primarily factual. *Mahoney v. Commissioner*, 808 F.2d 1219, 1220 (6th Cir. 1987), affg. 85 T.C. 127 (1985); *Enrici v. Commissioner*, 813 F.2d 293, 295 (9th Cir. 1987), affg. 85 T.C. 127 (1985). We have had before us several recent cases involving "off market" transactions of Government securities or commodities. See *Forseth v. Commissioner, supra*; *Brown v. Commissioner, supra*; *Price v. Commissioner*, 88 T.C. 860 (1987). In those three cases we found that the purported transactions were "factual shams" (*Forseth v. Commissioner*, 85 T.C. at 165; *Brown v. Commissioner*, 85 T.C. at 1000), and "fictitious, i.e., shams" (*Price v. Commissioner*, 88 T.C. at 883). In making this determination, we considered various factors such as: (1) the correlation of tax needs and the purported losses, (2) the use of "margin" requirements, (3) the methods by which the "transactions" were closed, (4) the manipulation of trading records, (5) the fact that the "dealer" was on two sides of the transaction and could execute the "transactions" at will, (6) the use of pricing formulae, and (7) the viability of the dealer's "hedging" program.

More than half of the transcript in this case involves expert testimony concerning the theoretical viability of First Western's program as a bona fide investment strategy and the reasonableness of its prices for forward contracts. In many instances,

[12] By using the term "off market" we are not referring to over-the-counter markets. Rather, we are referring to alleged markets where prices are not quoted to the public.

we have no reason to doubt the general testimony of petitioners' experts. On the other hand, we are left with the very firm impression that petitioners' expert witnesses were either not given the total facts or ignored many of the gremlins in the First Western program. There, perhaps, is not a single salient gremlin that alone leads us to conclude that the transactions of First Western's world were illusory and fictitious. Rather, it is the cumulation of simply too many gremlins.

Risk of Profit and Loss

First Western was continually on all sides of these transactions. In a transaction involving the purchase or sale of forward contracts, First Western was on the opposite side, it was the market maker and it represented purchaser or seller — its customer. First Western also established the prices. Furthermore, at will, it could change positions in the portfolios. These aspects may not be necessarily fatal to the alleged bona fides of these transactions, but they do cause misgivings, particularly where only approximately 3 percent of the accounts made money, and of this group, First Western employees were the largest winners.[13]

Petitioners presented voluminous expert testimony on the profit potential of the program. But what concerns us is that, if the profit potential was not a legerdemain, why were potential losses of customers limited to the amount of margin payments.[14] In short, we are asked to believe that, while customers' losses

[13] At trial there were objections by petitioners to the testimony concerning First Western's employees as winners. We first note that we requested that the parties brief the issues. Petitioners have not addressed these objections on brief and, therefore, we assume that the objection is waived. Furthermore, after a review of these objections, we believe that they are without merit.

[14] First Western employees testified that there was no such agreement with customers. Petitioner Freytag's letter to First Western and First Western's pamphlet to McCoin put an end to that charade.

were limited, their profits were unlimited. The wearing of judicial robes does not require that we take leave of commonsense. If First Western controlled losses by its system, that system also would have to control profits, and, as Mr. Taylor's letter to Dr. Womble indicates, First Western could fine-tune its program to reach any result.

Petitioners' portfolios were constructed so as to achieve their desired tax losses. In this regard, the most important required data supplied by petitioners were their requested tax losses. Indeed, the program could not be implemented without the tax information. Thus, in analyzing the program from a profit standpoint, from the first, the tax tail wagged an economic dog. Furthermore, First Western's uncanny ability to produce almost precise tax results belies the image that the program was not capable of carefully controlling results.

Petitioners rely on the fact that certain customers, other than First Western employees, did make money, to argue that the potential for profit, therefore, was real. We believe, however, that the few cases where customers received more than they put in were simply "window dressing." Even in so-called "Ponzi" schemes there are some winners. See ***Murphy v. Commissioner***, 661 F.2d 299 (4th Cir. 1981), affg. a Memorandum Opinion of this Court. But that fact does not give any economic substance to the scheme.

Hedging

Also crucial to First Western's image as a market "dealer" was its alleged hedging system. First Western allegedly maintained a hedging account with Conti. But we find little, if any, correlation between that account and First Western's alleged risk exposure through its forward contracts. Indeed, on at least one occasion, First Western "hedged" the wrong way. Putting aside First Western's method of computing its risks, which is in itself suspect, not even petitioners' primary expert on hedging

would conclude that the hedging program was operated in a manner that was consistent with sound business practices.[15] Needless to say, respondent's expert witnesses were even less enthusiastic concerning the sound business practice of First Western's hedging program. We recognize that bona fide dealers may make a decision to be exposed by not being fully hedged. But in those situations, there is a conscious decision by management to take such a risk. Here the risk was already controlled, and First Western's account with Conti was not a bona fide hedging account.

Margins and Fees

First Western's methods of using margins and collecting fees, when compared with normal practice, can only be characterized as bizarre. Essentially, the amount of the margin was determined by the tax loss requested. It was not a good-faith deposit to protect a dealer against loss. Rather, it was the source from which fees were charged. First Western's internal documents show that fees were budgeted or deducted from the margin accounts prior to any trading activity, and, when the "fee cap" was reached, no further fees were collected regardless of the number of subsequent transactions. Furthermore, as we have found, the amount of the margin limited the customers' potential losses. Finally, even when "margin calls" were made, they were frequently ignored, except when another program for the next year was started, and then the "margin calls" were, as Mr. Maule recognized, nothing more than a device used to implement the subsequent year's "tax preference."

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[15] Petitioners' expert later expressed the view that in light of First Western's capital structure in March 1981 of $17 million, First Western's risk was not unacceptable. While at that particular time the risk compared to capital might have been reasonable, that does not explain the reasonableness of the risk before and after that period when the capital was substantially less and the risk exposure just as great. We do not find this latter testimony persuasive. Even a blind squirrel may find a nut now and then.

Pricing

An enormous amount of testimony of the experts focused on the prices of First Western's forward contracts. One aspect of the pricing is clear — the prices were artifically generated by the pricing algorithms. This point is not in dispute. Petitioners contend, however, that even if the prices are artificially generated, they should be recognized as "valid" because they closely approximated market prices.

Here, not unlike Macduff, we were "Laid on." Petitioners introduced a vast amount of testimony and studies tending to show that First Western's prices were reasonable. These studies were primarily based on regression analyses to product standard deviations between First Western's prices and the Telerate and/or Wall Street Journal prices. Respondent's experts, on the other hand, primarily based their studies on absolute price differences between First Western generated prices and the Telerate and/or Wall Street Journal prices. We are persuaded that respondent's analyses are more meaningful. A brief example is sufficient to illustrate our reasoning. If there are two observations of price differences, one of which is $10 too high and the other $10 too low, the standard deviation (or "r²") would be zero, suggesting that First Western's pricing was accurate, even though there are vast differences in the prices. In short, in a standard deviation analysis, overpricing by the algorithm is offset by underpricing. Accordingly, we find that the absolute (or mean absolute) difference analyses by respondent more accurately reflect the reasonableness of First Western's prices.

Without going through each study, one of the most significant aspects revealed is that the algorithm systematically overpriced lower coupons and underpriced higher coupons. (Indeed, petitioners' evidence confirms this aspect of the pricing algorithms, although the price differences are not as dramatic

under petitioners' regression analyses.) Furthermore, respondent's analyses of First Western pricing showed, inter alia, cash price differences for coupons priced using First Western's algorithm and Telerate historical prices as large as $6.73, and 580 cases (24 percent of the observations) the differences were $4 or more. A comparison of First Western generated prices and Telerate prices for 1- through 4-month forward contracts was equally off the mark.

These differences are highly significant. Given the enormous legs of the straddles, if one leg is overpriced or underpriced, the gain or loss may be clearly controlled. Having written the pricing algorithms, First Western surely understood their mathematical properties, and, therefore, could, and did, utilize its prices to obtain any result it desired. This certainly is consistent with the bizarre operations of the so-called hedging account and First Western's ability to limit losses. It also explains the reason that First Western could not, and did not, quote prices to bona fide dealers. In a sentence, if it had, it would have been arbitraged out of existence by a dealer purchasing or selling at these prices and taking the opposite position in the cash market.[36]

Closing the Transactions

Petitioners used three methods of closing its customers' transactions — cancellation, setoff, and assignments. We are primarily concerned with the use of cancellation and assignments, since these devices were used by First Western to create the tax benefits its customers sought. As we have found, First Western's uses of these devices were far different from those in the "real world."

[36] While there was a sharp dispute as to the appropriate band of arbitrage — viz. when the spread between prices is arbitragable — differences of over $2 clearly fall without that band.

The manner in which the assignments were effected also reveals the nature of these transactions. The customer "assigned" his contracts to one of the three assignees. In essence, his account was credited with approximately 99 percent of the net value of the contracts. The assignee's account was credited with the full value of the contracts and debited by the amount paid to the assignor. First Western then cancelled or set off the contracts and paid the assignee approximately 1 percent of full value. There was no negotiation over prices at the time of the assignments, cancellations, or setoffs. The prices were set by First Western all the way through, even though the assignees were allegedly purchasing the contracts that provided for delivery to or from the customers. There is clearly more than a touch of whimsy in these transactions.

There are also other gremlins in First Western's program that dispel the notion that these transactions were bona fide — e.g., reversing transactions months later, assignments and confirmations being sent months after the transactions allegedly took place, margin demands not being satisfied, transactions being entered into without any documented correspondence with the customer or his representative, etc. While petitioners' experts have attempted to cast some of these facts in terms of "normal market" glitches, we are not persuaded. Perhaps, taken in isolation, there may be some validity to the explanations, but, taken together, First Western's operation could not have existed if there had been any real economic substance to its program. In short, petitioners ignore what happened and depend on a thoretical justification of what did not happen. First Western's world consisted of a computer spitting out paper showing huge transactions that had no economic significance except in petitioners' attempts to raid Federal and State fiscs.

2. *Even if there were bona fide market transactions, those transactions were not entered into primarily for economic purposes and are not recognized for Federal tax purposes.*

While we could stop here, there is an alternative basis for rejecting petitioners' claims. Section 165(c)(2) permits individuals to deduct losses incurred in any transaction entered into for profit. In *Glass v. Commissioner*, 87 T.C. 1087 (1986), we discussed in detail the background that gave rise to the theoretical basis for favorable treatment of trading straddles, and we will not repeat that discussion here. We summarized our views as follows (87 T.C. at 1175):

> Section 165 allows us a deduction any loss sustained during the taxable year and not compensated by insurance or otherwise. Section 1234 determines the character of gains and losses attributable to option transactions, including commodity options. New section 108(a) allows losses sustained by investors in straddle, transactions if incurred in a transaction entered into for a profit. * * *

"New section 108(a)" refers to section 108 ("old section 108") of the Tax Reform Act of 1984 (Division A of the Deficit Reduction Act of 1984, Pub. L. 98-369, 98 Stat. 494, 630), as amended by section 1808(d) of the Tax Reform Act of 1986, Pub. L. 99-514, 100 Stat. 2817.

Prior to section 108 of the 1984 Act ("old section 108"), the Court had found that there were not any non-tax profit objectives in transactions involved in so-called "butterfly" straddles and held that the taxpayers did not have the requisite economic profit objective necessary to enable them to deduct the commodity tax straddle losses" under section 165(c)(2). *Smith v. Commissioner*, 78 T.C. at 394. Subsequently, we held

that under section 165(c)(2) the proper test was whether the taxpayer's "primary" motive was economic, except where the "transactions * * * are unmistakably within the contemplation of congressional intent" to encourage such investments. *Fox v. Commissioner*, 82 T.C. at 1021.

We next considered the effect of "old section 108" in *Miller v. Commissioner*, 84 T.C. 827 (1985), on appeal (10th Cir., Nov. 20, 1985). In *Miller*, we recognized that the transactions were "primarily tax motivated." 84 T.C. at 837. Nonetheless, the Court held that section 108(a)[17] "directs that losses be allowed on the disposition of a position if that particular straddle transaction can be said to have held 'a reasonable prospect of any profit' at the time the straddle was acquired." 84 T.C. at 842.

Section 1808(d) of the 1986 Act[18] amended "old section 108." In *Glass v. Commissioner*, 87 T.C. at 1167, we summarized the amended version of section 108:

[17] SEC. 108(a) GENERAL RULE. — For purposes of the Internal Revenue Code of 1954, in the case of any disposition of 1 or more positions —

(1) which were entered into before 1982 and form part of a straddle, and

(2) to which the amendments made by title V of the Economic Recovery Tax Act of 1981, do not apply.

any loss from such disposition shall be allowed for the taxable year of the disposition if such position is part of a transaction entered into for profit.

(b) PRESUMPTION THAT TRANSACTION ENTERED INTO FOR PROFIT. — For purposes of subsection (a), any position held by a commodities dealer or any person regularly engaged in investing in regulated futures contracts shall be rebuttably presumed to be part of a transaction entered into for profit.

[Tax Reform Act of 1984, Pub. L. 98-369, sec. 108, 98 Stat. 630.]

[18] Sec. 1808(d) of the Tax Reform Act of 1986 amended sec. 108 as follows:

(d) SECTION 108. — Section 108 of the Tax Reform Act of 1984 is amended —

(1) by striking out "if such position is part of a transaction entered into for profit" and inserting in lieu thereof "if such loss is incurredc in a trade or business, or if such loss is incurred in a transaction entered into for profit though not connected with a trade or business,"

(2) by striking out subsection (b) and inserting in lieu thereof the following:

In summary, then, amended section 108 traces the pattern of the loss provisions of section 165(c)(1) and (2), and makes it clear that losses incurred by commodities dealers trading in commodities are deductible under section 108 since they are losses incurred in a trade or business. Investors, on the other hand, must meet the test of loss incurred in a transaction entered into for profit. In the context of commodity straddle transactions, the investor language parallels the section 165(c)(2) language which we construed in *Smith* and *Fox*, and (except as to commodities dealers) we think the effect of amended section 108 is to revalidate our holdings in those cases.

"(b) LOSS INCURRED IN A TRADE OR BUSINESS. — For purposes of subsection (a), any loss incurred by a commodities dealer in the trading of commodities shall be treated as a loss incurred in a trade or business.",

(3) by striking out the heading for subsection (c) and inserting in lieu thereof the following:

"(c) NET LOSS ALLOWED. — ",

(4) by striking out subsection (f) and inserting in lieu thereof the following:

"(f) COMMODITIES DEALER. — For purposes of this section, the term 'commodities dealer' means any taxpayer who —

"(1) at any time before January 1, 1982, was an individual described in section 1402(i)(2)(B) of the Internal Revenue Code of 1954 (as added by this subtitle), or

"(2) was a member of the family (within the meaning of section 704(e)(3) of such Code) of an individual described in paragraph (1) to the extent such member engaged in commodities trading through an organization the member of which consisted solely of —

"(A) 1 or more individuals described in paragraph (1), and

"(B) 1 or more members of the families (as so defined) of such individuals.", and

([5]) by striking out subsection (h) and inserting in lieu thereof the following

"(h) SYNDICATES. — For purposes of this section, any loss incurred by a person (other than a commodities dealer) with respect to an inte.est in a syndicate (within the meaning of section 1256(e)(3)(B) of the Internal Revenue Code of 1954) shall not be considered to be a loss incurred in a trade or business.

[Sec. 1808(d), Tax Reform Act of 1986, Pub. L. 99-514, 100 Stat. 2817-2818.]

The initial question that arises under our holdings in *Smith* and *Fox* is whether these transactions were "unmistakable within the contemplation of congressional intent" for affording special tax consideration. Even if we were to accept petitioners' view of this program (which we do not), the economic raison d'etre for these transaction was to permit the customers to speculate on interest rates. But rank speculation is generally not considered the type of investment that Congress has sought to foster, and petitioners have not shown us expressions of congressional intent to encourage investments of this nature. Furthermore, we doubt seriously that Congress would ever encourage a speculative device where the primary by-product is to shift income from one year to another. Thus, under the *Smith* and *Fox* analyses, petitioners must show that their primary motivation in entering into these transactions was economic profit.

Petitioners urge that there was a profit potential here as evidenced by the fact that some of the petitioners actually made money. But the fact that there may have been winning participants does not answer the question whether the transactions were primarily entered into for profit. While the petitioners testified that their primary motive or intent was to make a profit, the documents and the parties' actions direct a different conclusion.

Petitioners focus upon First Western's promotional material and point out that the tax consequences are not mentioned. From this we are asked to minimize the role that tax considerations could have played in its customers' decisions to invest in its program. First, it is quite clear from the 1978 pamphlet given to McCoin that First Western always emphasized the perceived tax advantages. Furthermore, the promotions of the so-called finders paint an entirely different picture. In that picture, the economic potential is described by one finder as the "gravy," and generally there was no discussion of economic

gain. It was generally assumed that a customer would lose most, if not all, of his payment. Clearly, the program was sold because of its perceived tax advantages, with little or no emphasis on the economic potential.

This conclusion is reinforced by the manner in which petitioners regarded these transactions with First Western. Few, if any, petitioners had the slightest idea of the operations of the program. Dr. Womble did not even understand what he had allegedly bought and sold. Few, if any, petitioners ever attempted to check prices or could even determine whether their "interest forecast" was implemented. On the other hand, all of the petitioners and their finders were acutely aware of the perceived tax benefits and the finders' analyses of potential success of the program was based on the tax benefits. Indeed, Col. Harby was so focused on the tax benefits that he eschewed a $30,000 profit to increase a tax loss.

In short, it is simply ludicrous to suggest that these petitioners had anything but a most fleeting interest in a potential economic gain. Thus, even if the transactions were market transactions, this program was driven almost exclusively, and certainly primarily, by tax considerations. Accordingly, under our holdings in *Smith, Fox,* and *Glass*, petitioners may not deduct these losses under the applicable loss provisions of the Internal Revenue Code.

3. *Deductions for amounts paid to First Western and to the "finders," and inclusion in income of "profits"*

Petitioners who claimed deductions for investment services have not shown that the amounts deducted were for services other than those related to First Western transactions. The amounts paid to First Western and to the various finders were paid to purchase perceived tax deductions and are not deductible and are not deductible under section 162 or section 212.

Brown v. Commissioner, 85 T.C. at 1000, and cases cited therein. The gains from First Western forward contract transactions reported in other years, as with the losses, are not recognized for tax purposes. To the extent, however, that any petitioners received more from First Western than they paid to First Western during the years before the Court, the excess is ordinary income. *Murphy v. Commissioner*, 661 F.2d 299 (4th Cir. 1981), affg. T.C. Memo. 1980-218.

4. *Section 6621.*

Section 6601 provides that "if any amount of tax * * * is not paid on or before the last date prescribed for payment, interest * * * [as determined by section 6621] shall be paid for the period from such last date to the date paid." Section 6621(a)(2) provides the general rule that the rate of interest for underpayments shall be the "short term Federal rate" plus "3 percentage points." In the case, however, of a "substantial underpayment attributable to tax motivated transactions" shall be 120 percent of the rate under section 6621(a)(2). Sec. 6621(c)(1). A "substantial underpayment" is an underpayment exceeding $1,000 attributable to one or more "tax motivated transactions." Sec. 6621(c)(2). "Tax motivate transactions" are defined, inter alia, as "any sham or fraudulent transaction." Sec. 6621(c)(3)(A)(v). We have found that these transactions were illusory and fictitious, i.e., shams. Accordingly, the underpayments resulting from the losses and related deductions claimed on petitioners' returns are attributable to tax-motivated transactions and the interest on these underpayments shall be computed under section 6621(c)(1).

5. *Negligence.*[39]

Section 6653(a) provides that if any part of an underpayment "is due to negligence or intential disregard of rules and regulations (but without intent to defraud), there shall be added to the tax an amount equal to 5 percent of the underpayment." Petitioners have the burden of proving that their actions in claiming these losses were not negligent. *Forseth v. Commissioner*, 85 T.C. at 166.

"Negligence is a lack of due care or the failure to do what a reasonable and ordinarily prudent person would do under the circumstances." *Marcello v. Commissioner*, 380 F.2d 499, 506 (5th Cir. 1967), affg. on this issue 43 T.C. 168 (1964); T.C. Memo. 1964-299, cert. denied 389 U.S. 1004 (1968); *Zmuda v. Commissioner*, 731 F.2d 1417, 1422 (9th Cir. 1984), affg. 79 T.C. 714 (1982).

In these cases, all petitioners had backgrounds and knowledge that should have alerted them to the fact that something was wrong with First Western's program. While their vocations varied, all petitioners had some business and/or investment background, and there were clearly sufficient gremlins that would have required a reasonably prudent person to step back and take another look. We do not find any attempt by petitioners Ames, Timm, Poulos, Lewis, and Womble to take even the most elementary steps to investigate. They were told about the perceived tax advantages that, especially when compared with the payment, were enormous. As we have noted in our findings that fact, these petitioners then entered into the alleged transactions with little or no understanding of what they were doing, even though, if we accept the literal terms of the forward contracts, they could be required to make or receive delivery of

[39] Additions to tax under sec. 6653(a) were determined against petitioners Freytag, Timm, Poulos, Lewis, Ames, Womble, and McCoin.

millions of dollars of GNMA's and FMAC's. Furthermore, this was during a period of time when, as the Ninth Circuit has observed, there was "extensive continuing press coverage of questionable tax shelter plans." See *Zmuda v. Commissioner*, 731 F.2d at 1422, and references cited therein.

Petitioners Ames, Poulos, Timm, Lewis, and Womble, however, contend that they satisfied the reasonable and prudent person standard by relying on the advice of their investment counselors. We are not persuaded. While there are situations where reliance on expert advice may satisfy this standard, these petitioners do not fall within that rationale. Reliance on professional advice, but rather a factor to be considered. First, it must be established that the reliance was reasonable. There is no showing that petitioners were negligent in relying on the advice given by attorneys or certified public accountants with respect to the tax consequences of the transactions at issue if they had substance. However, there is also no showing that petitioners consulted any experts with respect to the bona fides of the financial aspects of the transactions. One of the attorneys (Mr. Taylor) giving tax advice specifically testified that he was "no expert" on such matters, and we believe that, if he had known the facts, he would not have given the advice that he did. Moreover, his client testified that he had no knowledge that Mr. Taylor had experience or expertise in this area. Similarly, while Mr. Burns was a CPA, he had no market experience upon which to base an opinion that Mr. Ames could reasonly rely on. There is nothing in the record to indicate that Messrs. Neese or Schmidt had any expertise in this area. Taking into account the novel nature of First Western's program and the huge tax writeoffs, we believe further investigation was mandated.[40] See *Saviano v. Commissioner*, 765 F.2d 643, 654 (7th

[40] Messrs. Taylor and Burns testified that they solicited the views of other professionals concerning First Western. We do not know, however, if this was communicated to their clients, nor do we know the particular expertise of the persons contacted.

Cir. 1985), affg. 80 T.C. 955 (1983). We also recognize that many people make investments on the touts of even strangers, but, simply because many people do, does not establish reasonable and prudent conduct. In short, if there had been any real examination of the program, "No reasonable person would have expected this scheme to work." Compare *Hanson v. Commissioner*, 696 F.2d 1232, 1234 (9th Cir. 1983), affg. a Memorandum Opinion of this Court. Accordingy, petitioners Ames, Timm, Poulos, Lewis, and Womble have not carried their burden of proof on this issue.

All that we have said also applies to Messrs. Freytag and McCoin; however, both petitioners face additional problems. Mr. Freytag, while perhaps not professionally concentrating on the tax aspects of securities transactions, certainly was no stranger to the tax laws. He was informed about First Western by some of his law partners and allegedly "did some research as to the investments." He knew that the so-called "margin" was a charade. The only conclusion that is possible on this record is that Mr. Freytag knew that First Western's program was controlled to the point that any meaningful risk was virtually nonexistent, and, therefore, these could not have been bona fide transactions. Nonetheless, he filed returns claiming losses based on this program. Warning bells tolled, but he ignored them. Mr. Freytag's actions were, at the very least, negligent.

Mr. McCoin's situation is somewhat similar. Mr. McCoin has degrees in finance and economics. He also knew that any risk was limited to the "margin" and that the "margin" was geared to the tax loss requested. Thus, he must have known that First Western's program depended on controlled results with only a vague reference to market forces. As with Mr. Freytag, with Mr. McCoin's background, the warnings bells surely rang loud and clear and he ignored them. Both had to know that the investment was simply too good to be valid taxwise.

6. *Section 6673 and Rule 33(b).*

Section 6673 provides that if "it appears to the Tax Court * * * that the taxpayer's position in * * * proceedings is frivolous or groundless, damages in an amount not in excess of $5,000 shall be awarded to the United States." In *Brown v. Commissioner*, 85 T.C. at 1002, while we eschewed awarding damages, we stated:

> We hereby serve notice, however, that henceforth we will have no reluctance with respect to petitioners who file petitions or maintain positions based upon transactions which they knew or reasonably should have known to be factual shams.

We have found, inter alia, that the transactions here were essentially illusory and fictitious, similar to those in *Brown*, and we are tempted to award damages. As discussed in the previous section of this opinion, there clearly were warning bells that any reasonable and prudent person should have heard. In the exercise of our discretion, however, we will again eschew awarding damages even though these cases are nothing more than variants of *Brown*.

There are, however, other groups of cases involving similar types of transactions that may fall either within the factual patterns of this case and *Brown* or the *Glass* case. We serve notice, therefore, that the cases addressed in this opinion are the last free bites of that apple.

We also caution future counsel that Rule 33(b) provides:

> The signature of counsel or a party constitutes a certificate by him that he has read the pleading that, to the best of his knowledge, information, and belief formed after reasonable inquiry, it is well grounded

> in fact, and is warranted by existing law or a good faith argument for the extension, modification, or reversal of existing law, and that is not interposed for any improper purpose, such as to harass or to cause unnecessary delay or needless increase in the cost of litigation. * * * If a pleading is signed in violation of this rule, the Court, upon motion or upon its own initiative, may impose upon the person who signed it, a represented party, or both, an appropriate sanction, which may include an order to pay to the other party or parties the amount of the reasonable expenses incurred because of the filing of the pleading, including reasonable counsel's fees.

We are aware that sometimes a client may insist that a case be litigated even when the chances of success are virtually nonexistent. But counsel also owes a duty to this Court. See rule 3.1, A.B.A. Model Rules of Professional Conduct and Code of Judicial Court (Aug. 1983 ed.). If tension exists between that duty and a client's insistence on litigating unmeritorious claims, counsel must evaluate Rule 33(b). Compare *Kalgaard v. Commissioner*, 764 F.2d 1322, 1324 (9th Cir. 1985), affg. a Memorandum Opinion of this Court.

Decisions will be entered under Rule 155.[41]

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[41] While Rule 155 computations may be unnecessary in some cases, it is unclear to us whether the parties are in agreement. Accordingly, we will let the parties sort out these problems, if any.

APPENDIX TO TAX COURT OPINION

1. The deficiencies in these cases are as follows:

Docket No.	Petitioners	TYE Dec. 31 —	Deficiencies: Tax	Deficiencies: Sec. 6653(a)
4934-82	Thomas L. and	1978	$35,269.80	$1,763.49
	Sharon N. Freytag	1979	51,101.00	2,255.05
9307-82	Bert C. and	1978	17,556.00	878.00
	Mildred H. Timm	1979	15,544.00	777.00
		1980	43,518.00	2,176.00
27146-82	Horace D. and			
	Sandra S. Harby	1979	10,840.60	—
29012-82	Ernest and	1978	73,040.00	3,589.00
	Joyce Poulos	1979	100,447.00	5,022.00
		1980	84,347.00	4,206.85
1240-83	Littleton G. Lewis, Jr.	1979	8,712.00	429.00
	and Irene R. Lewis	1980	11,482.00	574.00
3250-83	Joe D. and			
	Gladys E. Womble	1980	23,334.52	1,166.73
8616-83	Gerald T. and			
	Charlene K. Maule	1980	59,208.00	—
33016-83	Horace D. and	1980	27,684.07	—
	Sandra S. Harby	1981	9,318.00	—
204-84	Gerald T. and			
	Charlene K. Maule	1981	35,895.00	—
3749-84	Thomas L. and			
	Sharon N. Freytag	1980	49,946.00	2,497.00
7658-94	B. Charles and	1979	1,028,973.70	51,448.69
	Joyce G. Ames	1980	110,994.10	5,549.71
11821-84	Kenneth G. and			
	Candace G. McCoin	1980	52,836.44	2,641.82

2. At the time of filing their petitions, petitioners resided as follows:

Petitioners	Place of residence
Thomas L. and Sharon N. Freytag (Freytag)	Dallas, Texas
Littleton G., Jr., and Irene R. Lewis (Lewis)	Greenville, South Carolina

Petitioners	Place of residence
Horace D. and Sandra S. Harby (Harby)	Clemson, South Carolina
Ernest and Joyce Poulos (Poulos)	Dallas, Texas
Bert C. and Mildred H. Timm (Timm)	Plano, Texas
Joe D. and Gladys E. Womble (Womble)	Arlington, Texas
Gerald T. and Charlene K. Maule (Maule)	Tacoma, Washington
B. Charles and Joyce G. Ames (Ames)	Shaker Heights, Ohio
Kenneth G. and Candace G. McCoin (McCoin)	Houston, Texas

3. Petitioners filed income tax returns claiming deductions attributable to transactions with First Western that respondent disallowed as follows:

Petitioner	Year	Claimed deductions	
Freytag	1978	$70,739.00	Ordinary loss from cancellations
	1979	99,403.00	Ordinary loss from cancellations
		6,303.00	Net short-term capital loss from offsets [42]
	1980	101,794.00	Ordinary loss from cancellations
Poulos	1978	152,359.00	Ordinary loss from cancellations
		7,500.00	Investment counsel fee to Interplan, Inc.
	1979	183,416.00	Ordinary loss from cancellations

[42] Only $3,000 of this amount was used in 1979 because of the limit on the use of capital losses.

Petitioner	Year	Claimed deductions	
		2,000.00	Investment advisory fee
		10,500.00	Investment counsel fee to Interplan
	1980	167,244.00	Ordinary loss from cancellations
		$7,500.00	Investment counsel fee to Interplan
Timm	1978	50,476.24	Ordinary loss from cancellations
		2,500.00	Investment counsel fee to Interplan
	1979	12,633.00	Net short-term capital loss from offsets
		1,000.00	Investment counsel fee to Interplan
		5,000.00	Investment advisory fee
	1980	62,004.00	Ordinary loss from cancellations
		77,611.00	Net short-term capital loss from offsets
		844.00	Investment advisory fee to Samuels-Kramer
		6,750.00	Investment counsel fee to Interplan
Ames	1979	2,029,934.00	Ordinary loss from cancellations
		2,000.00	Investment advisory fee to Samuels-Kramer
	1980	146,395.00	Ordinary loss from cancellations
Harby	1979	54,777.00	Ordinary loss from cancellations

Petitioner	Year	Claimed deductions	
	1980	76,624.00	Ordinary loss from cancellations
		581.00	Net short-term capital loss from offsets
	1981	33,798.00	Ordinary loss from cancellations
Lewis	1979	49,305.00	Ordinary loss from cancellations
		300.00	Investment advisory fee
	1980	37,768.00	Ordinary loss from cancellations
		529.00	Net short-term capital loss from offsets
		1,600.00	Investment advisory fee
Maule	1980	117,642.00	Ordinary loss from cancellations
	1981	106,848.00	Ordinary loss from cancellations
Womble	1980	47,367.33	Ordinary loss from cancellations
McCoin	1980	113,771.00	Ordinary loss from cancellations

APPENDIX C.

United States Tax Court.

FIRST WESTERN GOVERNMENT SECURITIES, INC., ET AL.,[1] PETITIONERS *v.* COMMISSIONER OF INTERNAL REVENUE, RESPONDENT

Docket Nos. 25760-84, 32276-84, 33758-84, 22524-85, 6400-86, 21748-85, 25978-86, 2786-87. Filed April 9, 1990.

OPINION

NIMS, *Chief Judge*: These cases are before the Court on petitioners' motions to vacate the assignment of their cases to a special trial judge and to request that a Presidentially appointed Tax Court judge be assigned to consider these cases. By these motions, petitioners challenge the procedures which have been utilized by this Court for over 50 years. *See Appendix A*.

[1] For purposes of these motions, cases of the following petitioners are consolidated herewith: Sidney P. Samuels, docket No. 32276-84; Samuels, Kramer and Company, docket No. 33758-84; Sidney P. Samuels and Laurel M. Samuels, docket No. 22524-85; First Western Investments, Inc. and Subsidiaries, docket No. 6400-86; Samuels, Kramer and Company, docket No. 21748-86; Sidney P. Samuels and Laurel M. Samuels, docket No. 25978-86; First Western Investments, Inc. and Subsidiaries, docket No. 2786-87.

Respondent determined deficiencies in and additions to petitioners' Federal income taxes as follows:

			Additions to Tax — Sections				
Docket No.	Taxable Year	Deficiency	6653(b)	6653 (b)(1)	6653 (b)(2)	6661	6621 (c)
25760-84	1978	$ 6,042,502	$ 3,021,251	$ —	—	$ —	—
	1979	10,229,372	5,114,686	—	—	—	—
	1980	30,420,098	15,210,049	—	—	—	—
32276-84	1980	412,164	206,082	—	—	—	—
33758-84	1978	169,464	—	—	—	—	—
	1979	1,136,581	568,291	—	—	—	—
	1980	67,655	—	—	—	—	—
22524-85	1981	14,225,894	7,112,947	—	—	—	(2)
6400-86	1981	36,004,857	—	18,002,429	(1)	—	(2)
21748-86	1981	20,300	—	10,150	(1)	—	(2)
25978-86	1982	156,996	—	78,498	(1)	13,586	(2)
2786-87	1982	24,510,631	—	12,255,316	(1)	6,127,658	(2)

(1) 50% of the interest
(2) Interest will accrue at 120% of the normal rate

Unless otherwise indicated, all references to the Constitution are to the United States Constitution, all section references are to the Internal Revenue Code (Title 26 of the United States Code), and all Rule references are to the Tax Court Rules of Practice and Procedure.

At the time of filing their petitions, petitioners First Western Government Securities, Inc., First Western Investments, Inc. and Subsidiaries, and Samuels, Kramer and Company had their principal places of business in San Francisco, California, Reno, Nevada and New York, New York, respectively.

At the time of filing of their petitions, petitioners Sidney P. and Laurel M. Samuels were residents of San Francisco, California.

Background

Petitioners' cases raise issues similar to those raised in over 3,000 cases that have been filed in this Court. The common denominator of these cases is that each petitioner other than First Western Government Securities, Inc. (First Western) allegedly entered into financial transactions involving forward contracts for Government mortgage-backed securities with petitioner First Western.

From among the 3,000 above-mentioned cases, 12 cases (not including the cases now before us) were selected as test cases and were initially assigned by the chief judge of this Court to Judge Richard C. Wilbur. Subsequently, following Judge Wilbur's disability retirement on April 30, 1086, the cases were reassigned without objection pursuant to section 7456(d) (redesignated as section 7443A(b) by the Tax Reform Act of 1986, Pub. L. 99-514, section 1556, 100 Stat. 2755; see Appendix A) and Rule 180, to Special Trial Judge Carleton D. Powell. In due course the cases proceeded to trial and Opinion. The trial was held in San Francisco, California, and Washington, D.C., and consumed all or part of 16 weeks of trial time. Approximately 7,000 exhibits were received into evidence. On October 21, 1987, the Court agreed with and adopted the Opinion of Special Trial Judge Powell, reported as *Freytag v. Commissioner*, 89 T.C. 849 (1987). Rule 183(c); see Appendix B.

Pursuant to section 7443A and Rules 180, 181 and 183, petitioners' cases, which are part of the above-mentioned 3,000 case group, were also assigned to Special Trial Judge Powell. On October 12, 1989, petitioners filed identical motions to vacate the assignment of their cases to Special Trial Judge Powell. On January 16, 1990, respondent filed objections to the motions to vacate and memorandums of points and authorities in support of his objections. On February 15, 1990, petitioners filed reply memorandums to respondent's objections.

These cases have been consolidated solely for purposes of considering the motions to vacate.

The Tax Court was created by Congress under article I of the Constitution and is composed of 19 judges who are appointed by the President, by and with the advice and consent of the Senate. Section 7441 and 7443(a) and (b). At least biennially, the judges of the Tax Court designate one judge to be chief judge. Section 7444(b). The chief judge may appoint special trial judges. Section 7443A(a). Special Trial Judge Powell is one of 14 current special trial judges appointed by the chief judge.

The Court takes judicial notice that as of February 28, 1990, there were 54,428 cases pending in this Court. Of this number, 37,405 cases have been identified as having tax shelter issues. Of this number, 168 groups of related cases identified as involving tax shelter issues have been assigned under section 7443A(b)(4) to Special Trial Judges. These groups encompass approximately 14,500 cases.

Petitioners object to the assignment of these cases to Special Trial Judge Powell on the grounds that (1) section 7443A does not authorize the chief judge of the Tax Court to assign these cases to a special trial judge; and (2) the Appointments Clause of the United States Constitution article II, section 2, clause 2 does not permit Congress to authorize the chief judge of the Tax Court to appoint special trial judges.

In recognition of the well-established judicial preference of avoiding a constitution ruling if an independent statutory basis for a decision is available, we will first consider whether section 7443A authorizes the chief judge of the Tax Court to assign these cases to a special trial judge.

Section 7443A

Petitioners contend that the assignment by the chief judge of these cases to a special trial judge exceeds the authority conferred on the chief judge by section 7443A (see Appendix A) because the amount in dispute in each case exceeds $10,000.

Section 7443A(b) authorizes the chief judge to assign the following proceedings to special trial judges.

> (b) PROCEEDINGS WHICH MAY BE ASSIGNED TO SPECIAL TRIAL JUDGES. — The chief judge may assign —
>
> (1) any declaratory judgment proceeding,
>
> (2) any proceeding under section 7463 [see Appendix C],
>
> (3) any proceeding where neither the amount of the deficiency placed in dispute (within the meaning of section 7463) nor the amount of any claimed overpayment exceeds $10,000, and
>
> (4) any other proceeding which the chief judge may designate,
>
> to be heard by the special trial judge of the court.

Petitioners concede that paragraph (4), when read in isolation, allows the chief judge to assign any proceeding, including the present cases, to a special trial judge. However, petitioners assert that the language "any other proceeding" in paragraph (4) is actually limited to the type of proceedings described in paragraphs (1), (2) and (3) when paragraph (4) is read in conjunction with the other provisions of section 7443A(b). Petitioners contend that unless assignments under paragraph (4) are limited, paragraphs (1), (2) and (3) serve no purpose.

Respondent contends that paragraph (4) was added to section 7443A to allow the chief judge to assign proceedings distinct from those described in paragraphs (1), (2) and (3) to special trial judges. We agree with respondent.

Petitioners rely on *Gomez v. United States*, ___ U.S. ___, 109 S.Ct. 2237 (1989), to support their contention that proceedings that may be assigned under paragraph (4) are limited to the proceedings described in paragraphs (1), (2) and (3). *Gomez* addressed the issue of whether the Federal Magistrates Act (the Act) authorized United States district courts to assign jury selection in felony trials to magistrates. The Supreme Court determined that Congress did not intend to allow district courts to assign the duty of selecting juries in felony trials to magistrates under a clause in the Act allowing "additional duties" not otherwise prohibited to be assigned.

In *Gomez*, the Supreme Court analyzed the legislative history and structure of the Act and concluded that Congress did not intend to permit jury selection in a felony trial to be assigned to magistrates under the additional duties clause. Specifically, the Supreme Court stated:

> By a literal reading this additional duties clause would permit magistrates to conduct felony trials. But the carefully defined grant of authority to conduct trials of civil matters and of minor criminal cases should be construed as an implicit withholding of the authority to preside at a felony trial. The legislative history, with its repeated statements that magistrates should handle subsidiary matters to enable district judges to concentrate on trying cases, and its assurances that magistrates' adjudicatory jurisdiction had been circumscribed in the interests of policy as well as constitutional constraints, confirms this inference. Similar considerations lead us to conclude that

> Congress also did not contemplate inclusion of jury selection in felony trials among a magistrate's additional duties. [*Gomez v. United States*, ___ U.S. ___, 109 S.Ct. 2237, 2245-2246 (1989); fn. refs. omitted.]

In contrast, the legislative history and structure of section 7443A(b) show that Congress added paragraph (4) to allow the chief judge to assign proceedings not described in paragraphs (1), (2) and (3) to special trial judges. Thus, applying the Supreme Court's analysis in *Gomez* to section 7443A(b) shows that paragraph (4) authorizes the chief judge to assign the present cases to a special trial judge.

Paragraph (4) was added to present section 7443A(b) in 1984. Prior to 1984, the chief judge was authorized to assign to special trial judges only "any declaratory judgment proceeding, any small tax case, and any other proceeding where the amount in dispute [did] not exceed $5,000." H. Rept. No. 98-432 at 1568 (March 5, 1984). These are the proceedings currently found in paragraphs (1), (2) and (3) (with the dollar ceiling raised to $10,000).

The Supplemental Report of the Committee on Ways and Means, H. Rept. No. 98-432 at 1568 (March 5, 1984), states the reasons for adding paragraph (4) and the explanation of the change as follows:

> *Reasons for Change*
>
> The committee wishes to clarify that additional proceedings may be assigned to [Special Trial Judges] so long as a Tax Court judge must enter the decision.
>
> *Explanation of Provision*
>
> A technical change is made to allow the Chief Judge of the Tax Court to assign any proceeding to a special trial judge for hearing and to write proposed opinions, subject to review and final decision by a Tax Court judge, regardless of the amount in issue. However, special trial judges will not be authorized to enter decisions in this latter category of cases.

Because the legislative history and structure of section 7443A show that Congress intended to allow the chief judge to assign any proceeding to a special trial judge, provided that a Tax Court judge review the opinion and enter the decision, petitioners' reliance on *Gomez* is misplaced.

It is important to note that at the same time paragraph (4) was added to the present section 7443A(b) Congress also amended present section 7443A(c) to provide that a special trial judge could only enter decisions in proceedings assigned under paragraph (1), (2) and (3).

Section 7443A(c) provides:

> (c) AUTHORITY TO MAKE COURT DECISIONS. — The court may authorize a special trial judge to make the decision of the court with respect to any proceeding described in paragraph (1), (2), or (3) of subsection (b), subject to such conditions and review as the court may provide.

Before 1984, the present section 7443A permitted special trial judges to enter decisions in any proceedings assigned to them. However, after Congress amended present section 7443A(c), special trial judges were limited to entering decisions in the proceedings described only in subsection (b)(1), (2) and (3).

An assignment made under subsection (b)(1), (2) or (3) differs from an assignment made under subsection (b)(4) because a special trial judge may enter the decision of the Court

in an assignment made under the former but not the latter. Furthermore, reports in cases assigned under subsection (b)(4) must be reviewed and adopted by a Presidentially appointed judge of the Court. Rule 183(c); see Appendix B. In addition, where appropriate the chief judge may direct that such report be reviewed by the entire Tax Court. Section 7460(b). Thus, petitioners' contention that subsection (b)(4) subsumes subsection (b)(1), (2) and (3) is erroneous.

Accordingly, we conclude that section 7443A(b)(4) authorizes the chief judge to assign the present cases to a special trial judge.

Appointments Clause

We next consider petitioners' contention that section 7443A(a) authorizing the chief judge of the Tax Court to appoint special trial judges is unconstitution.

Section 7443A(a) provides:

> (a) APPOINTMENT. — The chief judge may, from time to time, appoint special trial judges who shall proceed under such rules and regulations as may be promulgated by the Tax Court.

Petitioners assert that article II, section 2, clause 2 of the Constitution (the Appointments Clause) precludes Congress from vesting the authority to appoint special trial judges in the chief judge of the Tax Court.

The Appointments Clause provides:

> [The President] shall nominate, and by and with the Advice and Consent of the Senate, shall appoint Ambassadors, other public Ministers and Consuls, Judges of the Supreme Court, and all other Officers of the United States, whose Appointments are not herein otherwise provided for, and which shall be established by Law; but the Congress may by Law vest the Appointment of such inferior Officers, as they think proper, in the President alone, in the Courts of Law, or in the Heads of Departments.

Officers of the United States

Petitioners first contend that special trial judges are principal officers of the United States who, under the Appointments Clause, may only be appointed by the President by and with the advice and consent of the Senate. Respondent argues that special trial judges are not principal or inferior officers of the United States, but employees of the Tax Court. Thus, respondent contends that the Appointments Clause does not in any way limit Congress' power to authorize the chief judge of the Tax Court to appoint special trial judges.

The Appointments Clause is not a discretionary provision but applies to the appointment of "all persons who can be said to hold an office under the government * * * ." *Buckely v. Valeo*, 424 U.S. 1, 125 (1976) (quoting *United States v. Germaine*, 99 U.S. 508, 509-510 (1879). However, not all employees of the government are officers of the United States. Persons who simply assist officers in discharging their duties are "lesser functionaries subordinate to officers of the United States." *Auffmordt v. Hedden*, 137 U.S. 310, 327 (1890); *United States v. Germaine*, 99 U.S. 508 (1879).

In contrast, an officer is an "appointee exercising significant authority pursuant to the laws of the United States * * * ." *Buckley v. Valeo, supra* at 126. Whether an individual is an officer rather than an employee "is determined by the manner in which Congress has specifically provided for the creation

of the several positions, their duties and appointment thereto." *Burnap v. United States,* 252 U.S. 512, 516 (1920).

The position of special trial judge was created by Congress through an amendment to the Internal Revenue Code. Section 958 of the Tax Reform Act of 1969, Pub. L. 91-172, 83 Stat. 487, 734. Special trial judges may be assigned any proceeding and may enter the decision of the Court in any declaratory judgment proceeding, any small tax case or any case in which the amount in dispute does not exceed $10,000. Section 7443A(b) and (c). Special trial judges are appointed for an indeterminate period, may be dismissed without restriction and receive 90 percent of the compensation of Presidentially appointed Tax Court judges. Section 7443A(a) and (d)(1); see *Ex parte Hennen,* 13 Peters 230, 258-259 (1839).

Because special trial judges may be assigned any case and may enter decisions in certain cases, it follows that special trial judges exercise significant authority. Thus, special trial judges are officers, not employees of the United States.

Principal and Inferior Officers

Petitioners assert that special trial judges are "principal" officers who must be appointed by the President by and with the advice and consent of the Senate. Respondent contends that the special trial judges are "inferior" officers. We agree with respondent.

"The Constitution for purposes of appointment * * * divides all its officers into two classes." *United States v. Germaine, supra* at 509. "Principal officers are selected by the President with the advice and consent of the Senate. Inferior officers Congress may allow to be appointed by the President alone, by the heads of departments, or by the Judiciary." *Buckley v. Valeo, supra* at 132.

The line between inferior and principal officers is one that is far from clear, and the Framers of the Constitution provided little guidance as to where it should be drawn. *Morrison v. Olson,* 487 U.S. 654, ___, 108 S.Ct. 2597, 2608 (1988). In determining whether a person is a principal or inferior officer, the Supreme Court has considered whether (1) a principal officer has the power to remove the officer; (2) the duties delegated are subject to limitations; (3) the jurisdiction of the office is limited; and (4) the appointment is temporary or permanent. *Morrison v. Olson,* 108 S.Ct. at 2608-2609.

The chief judge of the Tax Court, a principal officer, has the authority to appoint and remove special trial judges without restriction. Section 7443A(a); see *Ex parte Hennen, supra* at 258-259. The duties of special trial judges are defined and limited by the Order issued by the chief judge assigning a case to a special trial judge. Rules 180, 181, 182 and 183. Special trial judges may only enter the decision of the Court in declaratory judgment proceedings, small tax cases and cases in which the amount in dispute does not exceed $10,000, and in no others. Section 7443A(c).

Commissioners and magistrates serving other courts are considered to be inferior officers. *Go-Bart Importing Co. v. United States,* 282 U.S. 344, 352 (1931); *Rice v. Ames,* 180 U.S. 371, 378 (1901); *Pacemaker Diagnostic Clinic of America v. Instromedix,* 725 F.2d 537, 545 (9th Cir. 1984). We conclude that the duties and authority of special trial judges are similar to those of commissioners or magistrates.

The commissioners and magistrates in the above cases had more authority and greater protection from removal than special trial judges. Commissioners were empowered to issue arrest warrants, search warrants, and to arrest and imprison. *Go-Bart Importing Co. v. United States, supra* at 156. Magistrates may preside in any civil or misdemeanor trial with the consent of the parties. 28 U.S.C. section 636(c) (1982); 18 U.S.C. sec-

tion 3401(b) (1982). Magistrates are appointed for a term of years and can only be removed for cause while special trial judges are appointed for an indeterminate period and their employment may be terminated without cause, e.g., lack of work for them to perform, budgetary limitations, and the like. 28 U.S.C. section 631 (1982); see *Ex parte Hennen, supra* at 258-259.

Considering the limitations placed on the duties, jurisdiction and tenure of special trial judges, we conclude that special trial judges are inferior, not principal, officers of the United States.

Courts of Law

Petitioners assert that the Appointments Clause does not allow Congress to vest the authority to appoint inferior officers such as special trial judges in the chief judge of the Tax Court.

In *United States v. Germaine, supra* at 509-510, the Supreme Court stated that:

> The Constitution for purposes of appointment very clearly divides all its officers into two classes. The primary class requires a nomination by the President and confirmation by the Senate. But foreseeing that when offices became numerous, and sudden removals necessary, this mode might be inconvenient, it was provided that, in regard to officers inferior to those specially mentioned, Congress might by law vest their appointment in the President alone, in the courts of law, or in the heads of departments. * * *

Petitioners concede that Congress may vest the power to appoint inferior officers in the courts of law. However, petitioners assert that the term "Courts of Law" refers only to courts

created under article III of the Constitution. Thus, petitioners contend that because the Tax Court was created under article I of the Constitution, Congress may not vest the authority to appoint inferior officers in the chief judge of the Tax Court.

Respondent contends that the term "Courts of Law" refers to Article I as well as Article III courts, and therefore, Congress may vest the authority to appoint inferior officers in the chief judge of the Tax Court.

It is well established that the term "Courts of Law" includes Article III courts. *Morrison v. Olson*, 108 S.Ct. at 2609-2611; *Go-Bart Importing Co. v. United States, supra* at 156-157; *Rice v. Ames, supra* at 378.

The parties, however, do not cite a case addressing the issue of whether an Article I court is a court of law within the meaning of the Appointments Clause. The Court's own research has not revealed such a case. Therefore, the issue of whether an Article I court is a court of law, under the Appointments Clause, is one of first impression.

The Tax Court is a court of record established under article I of the Constitution. Section 7441. A "court of record" is generally defined as "a court that is required to keep a record of its proceedings, and that may fine or imprison." See Black's Law Dictionary, p. 319 (5th ed. 1979). We find nothing in the definition of a court of record to preclude a court such as the Tax Court from being a court of law as well.

Black's Law Dictionary, *supra* at 323, defines a court of law as follows:

> In a wide sense, any duly constituted tribunal administering the laws of the state or nation; in a narrower sense, a court proceeding according to the course of the common law and governed by its rules and principles, as contrasted with a "court of equity."

The Tax Court fits within the wide definition of the term "court of law" because it is a duly constituted tribunal administering laws of the United States.

The narrower definition of the term "court of law" implies that a court must have common law as contrasted with equitable powers to be a court of law. Whether an Article I court generally may exercise common law powers is unclear. See *Northern Pipeline Construction Co. v. Marathon Pipe Line Co.*, 458 U.S. 50, 59-60 (1982); cf. *Commodity Futures Trading Comm'n v. Schor*, 478 U.S. 833, 856-858 (1986).

Petitioners assert that the language of the Appointments Clause shows that the term "Courts of Law" refers to Article III courts. Thus, the commonly accepted definition of the term "court of law" is not the relevant definition.

The portion of the Appointments Clause permitting Congress to delegate the appointment of inferior officers (the delegation clause) provides:

> but the Congress may by Law vest the Appointment of such inferior Officers, as they think proper, in the President alone, in the Courts of Law, or in the Heads of Departments.

Petitioners contend that using the term "Heads of Departments" in conjunction with "Courts of Law" implies that the Clause refers to the executive and judicial branches of government. See *Buckley v. Valeo, supra* at 127. Accordingly, petitioners assert that the term "Courts of Law" refers only to Article III, not Article I, courts.

The delegation clause was proposed and adopted with no debate as to the meaning of the terms "Courts of Law" or "Heads of Departments." M. Farrand, 2 Records of the Federal Convention of 1787, pp. 627-628 (1966) (see Appendix D, *infra*); see also *Morrison v. Olson*, 108 S.Ct. at 2610. Thus, whether the term "Courts of Law" was intended for some reason to refer exclusively to Article III courts cannot be determined by examining the history of the delegation clause.

In *Ex parte Hennen, supra* at 257, the Supreme Court considered the term "Courts of Law" as used in the delegation clause and stated:

> The appointing power here designated, in the latter part of the section, was, no doubt, intended to be exercised by the department of the government to which the officer to be appointed most appropriately belonged. The appointment of clerks of courts properly belongs to the courts of law; and that a clerk is one of the inferior officers contemplated by this provision in the constitution cannot be questioned. * * *

The Supreme Court read the delegation power as "intended to be exercised by the department of the government to which the officer to be appointed most appropriately belonged." Thus, the Supreme Court considered that the purpose of the delegation clause was to allow Congress to vest the authority to appoint where it "most appropriately belonged."

In *Ex parte Siebold*, 100 U.S. 371, 397 (1880), the Supreme Court expanded the meaning of the delegation clause by stating:

> It is no doubt usual and proper to vest the appointment of inferior officers in that department of the government, executive or judicial, or in that particular executive department to which the duties of such officers appertain. But there is no absolute requirement to this effect in the Constitution * * *.

The Court read the delegation clause as permitting Congress to vest the appointment power either in the particular depart-

ment to which the duties of the officer pertain or in any other department of government. Thus, it is within the discretion of Congress to decide where the appointing power should be placed. *Morrison v. Olson*, 108 S.Ct. at 2610-2611.

Congress vested the authority to appoint special trial judges in the chief judge of the Tax Court. The delegation clause was intended to allow Congress to vest the authority to appoint inferior officers in the Court to which the officer to be appointed most appropriately belonged. Thus, reading the term "Courts of Law" to exclude the Tax Court would frustrate the purpose for which the delegation clause was created.

Nothing in the cases which have interpreted the delegation clause suggests that the clause was intended to deprive Congress of the power to vest the appointment power in a lawfully created governmental body should that body not fit within the terms "Heads of Departments" or "Courts of Law" as those terms were defined when the Constitution was adopted. To the contrary, the Supreme Court has read the delegation clause as giving Congress broad discretion in vesting the appointment power where Congress deems appropriate.

Congress long authorized the former Court of Claims, when an Article I court, to appoint its own commissioners and clerk. See W. Cowen, The United States Court of Claims — A History, 216 Ct.Cl. 1, 90-95, 177 (1978). Congress permits administrative agencies to appoint their own administrative law judges who perform duties similar to those of special trial judges. 5 U.S.C. section 3105 (1982).

Petitioners suggest that because administrative agencies do not come within the term "Heads of Departments," Congress may not vest the authority to appoint inferior officers in agencies either. However, the Supreme Court has upheld the authority of administrative agencies to delegate their adjudicatory functions including their fact-finding role, to administrative law judges. *Morgan v. United States*, 298 U.S. 468, 481 (1936).

Until 1969, the Tax Court was an independent agency in the executive branch. See *Martin v. Commissioner*, 358 F.2d 63, 64 (7th Cir. 1966). While an independent executive agency, the Tax Court would have been able to appoint its own special trial judges. See *Morgan v. United States, supra* at 481.

In 1969, the Tax Court was established by Congress as an Article I court. Section 7441. Petitioners, in effect, contend that by elevating the Tax Court to an Article I court Congress rendered itself powerless to authorize the Court to appoint its own special trial judges or even its own clerk. See *Ex parte Hennen, supra*. We find this conclusion untenable.

Legislative Officer

Petitioners further contend that because the Tax Court's authority is derived from Article I, the chief judge of the Tax Court is a legislative officer and that legislative officers are not permitted to appoint inferior officers under the Appointments Clause. See *Buckley v. Valeo, supra* at 127. We do not agree.

While the Tax Court's powers as an Article I court are not derived from Article III, those powers are nonetheless judicial. *Anthony v. Commissioner*, 66 T.C. 367, 369 (1976). The powers exercised by an officer, not the source of those powers, determine whether an officer is a legislative, executive or judicial officer under the Appointments Clause. *Buckley v. Valeo, supra* at 140-141. The Supreme Court held in *Williams v. United States*, 289 U.S. 553, 566-567 (1933), that Article I courts exercise judicial power. The Court stated that:

> The validity of this view is borne out by the fact that the appellate jurisdiction [or the Supreme Court's jurisdiction] over judgments and decrees of the legislative courts has been upheld and freely exercised

> under the acts of Congress from a very early period, a practice which can be sustained, as already suggested, only upon the theory that the legislative courts possess and exercise judicial power — as distinguished from legislative, executive, or administrative power — although not conferred in virtue of the third article of the Constitution.
>
> * * * * *
>
> If the power exercised by legislative courts is not judicial power, what is it? Certainly it is not legislative, or executive, or administrative power, or any imaginable combination thereof.

Because the powers exercised by the Tax Court are judicial powers, not legislative powers, Tax Court judges are judicial officers, not legislative officers. As judicial officers of the United States, Tax Court judges must be appointed by the President by and with the advice and consent of the Senate in accordance with the Appointments Clause. Section 7433(b).

Accordingly, petitioners' contention that the chief judge of the Tax Court is a legislative officer and thus cannot appoint inferior officers such as special trial judges is erroneous.

Chief Judge's Authority

Petitioners next contend that because the term "Courts of Law" in the delegation clause is in the plural form, Congress is required to vest the authority to appoint special trial judges in more than one judge of the Tax Court. We do not agree.

The terms "Courts of Law" and "Heads of Departments" in the delegation clause refer to the courts and departments which Congress is authorized to create. The term "Courts of Law" in no way implies that Congress must vest the authority to appoint special trial judges in more than one judge. Thus, we hold that Congress has properly vested the authority to appoint special trial judges in the chief judge of the Tax Court.

Accordingly, petitioners' motions to vacate will be denied.

* * * * *

Petitioners have requested that if their motions are denied the Court, pursuant to Rule 193 and section 7482(a)(2), include a statement in its Order that there is controlling question of law involved as to which there is a substantial ground for a difference of opinion and that an immediate appeal from the Order may materially advance the ultimate termination of the litigation. The Court's interlocutory Order, a copy of which is attached hereto as Appendix E, contains such a statement.

We point out that, while such a statement has been included to comply with the statutory requirement, the views of this Court are unanimous. Resolution of this issue, however, is of critical importance not only for this case but also for the functioning of the Court generally. Accordingly, we have taken the unusual step of certifying this issue for interlocutory appeal in order to obtain expeditious resolution of whatever difference of opinion there might be.

An appropriate order will be entered.

Reviewed by the Court.

CHABOT, PARKER, KORNER, SHIELDS, HAMBLEN, COHEN, CLAPP, SWIFT, JACOBS, WRIGHT, PARR, WELLS, WHALEN, and COLVIN, JJ., agree with this opinion.

GERBER and RUWE, JJ., did not participate in the consideration of this opinion.

TAX COURT APPENDIX A

Authority to use special trial assistants originated in section 1114 of the Internal Revenue Code of 1939, as amended by section 503 of the Revenue Act of 1943, Pub. L. 78-235, 58 Stat. 21, 72, when the Board of Tax Appeals existed only as an executive agency. At that time, Congress permitted the presiding judge "from time to time by written order [to] designate an attorney from the legal staff of the court to act as a commissioner in a particular case. * * * [to] proceed under such rules and regulations as may be promulgated by the [Tax] court." H. Rept. No. 871, 78th Cong., 1st Sess. (1943), 1944 C.B. 901, 954.

That provision was continued without substantial change as section 7456(c) of the 1954 Code. In 1969, when the status of the Tax Court was changed from that of an independent agency of the Executive Branch to that of an Article I court, this provision was amended to delete the reference to attorneys from the Tax Court's legal staff and to provide for appointment of full-time commissioners for indefinite terms. Section 7456(c) was amended by section 958 of the Tax Reform Act of 1969, Pub. L. 91-172, 83 Stat. 487, 734, 1969-3 C.B. 161. In addition, section 957 of the same Act provided for the creation of a streamlined procedure for disputes involving $1,000 or less at the option of the taxpayer (and concurred in by the Tax Court), an amount increased to $1,500 in 1972. (Pub. L. 92-512, section 203(b)(2), 86 Stat., 1972-2 C.B. 700).

In 1978, Congress increased the jurisdictional amount to $5,000, again amending section 7456(c) to allow the Tax Court to authorize commissioners to enter decisions in declaratory judgment proceedings, and added section 7463(g), providing the same authority in the case of small tax proceedings. Revenue Act of 1978, Pub. L. 95-600, sections 336(b)(1), 502(a)(1) and (b), 92 Stat. 2841, 2879, 1978-3 C.B. (Volume 1) 75-76,

113. The provisions allowing entry of decisions by commissioners were eventually consolidated in section 7456(d) and expanded in 1982 to encompass all three categories of cases now set forth in section 7443A(b)(1)-(3). Section 7456(d) of the Code was amended by section 106(c)(1) of the Miscellaneous Revenue Act of 1982, Pub. L. 97-362, 96 Stat. 1726, 1730.

The provisions took essentially their present form in 1984 when the term "commissioner" was formally changed to "special trial judge" and a provision corresponding to present section 7443A(b)(4) was added by sections 463(a) and 464(b) of the Tax Reform Act of 1984, Pub. L. 98-369, 98 Stat. 494, 824. In 1986, the provisions of former section 7456(c) and (d) were moved to new section 7443A by section 1556(a) of Pub. L. 99-514, 100 Stat. 2085, 2754-2755.

TAX COURT APPENDIX B

RULE 183. CASES INVOLVING MORE THAN $10,000

Except in cases subject to the provisions of Rule 182 [cases involving $10,000 or more] or as otherwise provided, the following procedure shall be observed in cases tried before a Special Trial Judge:

(a) Trial and Briefs: A Special Trial Judge shall conduct the trial of any such case assigned to him for such purpose. After such trial, the parties shall submit their briefs in accordance with the provisions of Rule 151. Unless otherwise directed, no further briefs shall be filed.

(b) Special Trial Judge's Report: After all the briefs have been filed by all the parties or the time for doing so has expired, the Special Trial Judge shall submit his report, including his findings of fact and opinion, to the Chief Judge, and the Chief Judge will assign the case to a Division of the Court.

(c) Action on the Report: The Division to which the case is assigned may adopt the Special Trial Judge's report or may modify it or may reject it in whole or in part, or may direct the filing of additional briefs or may receive further evidence or may direct oral argument, or may recommit the report with instructions. Due regard shall be given to the circumstance that the Special Trial Judge had the opportunity to evaluate the credibility of witnesses, and the findings of fact recommended by the Special Trial Judge shall be presumed to be correct.

TAX COURT APPENDIX C

SEC. 7463. DISPUTES INVOLVING $10,000 OR LESS.

(a) IN GENERAL. — In the case of any petition filed with the Tax Court for a redetermination of a deficiency where neither the amount of the deficiency placed in dispute, nor the amount of any claimed overpayment, exceeds —

(1) $10,000 for any one taxable year, in the case of the taxes imposed by subtitle A,

(2) $10,000, in the case of the tax imposed by chapter 11,

(3) $10,000 for any one calendar year, in the case of the tax imposed by chapter 12, or

(4) $10,000 for any 1 taxable period (or, if there is no taxable period, taxable event) in the case of any tax imposed by subtitle D which is described in section 6212(a) (relating to a notice of deficiency),

at the option of the taxpayer concurred in by the Tax Court or a division thereof before the hearing of the case, proceedings in the case shall be conducted under this section. Notwithstand-

ing the provisions of section 7453, such proceedings shall be conducted in accordance with such rules of evidence, practice, and procedure as the Tax Court may prescribe. A decision, together with a brief summary of the reasons therefor, in any such case shall satisfy the requirements of sections 7459(b) and 7460.

(b) FINALITY OF DECISIONS. — A decision entered in any case in which the proceedings are conducted under this section shall not be reviewed in any other court and shall not be treated as a precedent for any other case.

(c) LIMITATION OF JURISDICTION. — In any case in which the proceedings are conducted under this section, notwithstanding the provisions of sections 6214(a) and 6512(b), no decision shall be entered redetermining the amount of a deficiency, or determining an overpayment, except with respect to amounts placed in dispute within the limits described in subsection (a) and with respect to amounts conceded by the parties.

(d) DISCONTINUANCE OF PROCEEDINGS. — At any time before a decision entered in a case in which the proceedings are conducted under this section becomes final, the taxpayer or the Secretary may request that further proceedings under this section in such case be discontinued. The Tax Court, or the division thereof hearing such case, may, if it finds that (1) there are reasonable grounds for believing that the amount of the deficiency placed in dispute, or the amount of an overpayment, exceeds the applicable jurisdictional amount described in subsection (a), and (2) the amount of such excess is large enough to justify granting such request, discontinue further proceedings in such case under this section. Upon any such discontinuance, proceedings in such case shall be conducted in the same manner as cases to which the provisions of sections 6214(a) and 6512(b) apply.

(e) AMOUNT OF DEFICIENCY IN DISPUTE. — For purposes of this section, the amount of any deficiency placed in disputed includes additions to the tax, additional amounts, and penalties imposed by chapter 68, to the extent that the procedures described in subchapter B of chapter 63 apply.

(f) QUALIFIED STATE INDIVIDUAL INCOME TAXES. — For purposes of this section, a deficiency placed in dispute or claimed overpayment with regard to a qualified State individual income tax to which subchapter E of chapter 64 applies, for a taxable year, shall be treated as a portion of a deficiency placed in dispute or claimed overpayment of the income tax for that taxable year.

TAX COURT APPENDIX D

M. Farrand, 2 Records of the Federal Convention of 1787, pp. 627-628 (1966)

> Art II. sect. 2. (paragraph 2) To the end of this, Mr Governr. Morris moved to annex "but the Congress may by law vest the appointment of such inferior Officers as they think proper, in the President alone, in the Courts of law, or in the Heads of Departments." Mr. Sherman 2ded. the motion
>
> Mr. Madison. It does not go far enough if it be necessary at all — Superior Officers below Heads of Departments ought in some cases to have the appointment of the lesser offices.
>
> Mr Govr Morris. There is no necessity. Blank Commissioners can be sent —
>
> On the motion

> N.H. ay. Mas — no — Ct ay. N.J. ay. Pa. ay. Del. no. Md. divd. Va no. N.C. ay — S C no. Geo — no — [Ayes — 5; noes — 5; divided — 1.]
>
> The motion being lost by the equal division (of votes,) It was urged that it be put a second time, some such provision being too necessary, to be omitted, and on a second question it was agreed to nem. con.

TAX COURT APPENDIX E

UNITED STATES TAX COURT
Washington, D.C. 20217

FIRST WESTERN GOVERNMENT	Docket Nos. 25760-84
SECURITIES INC., ET AL.,	32276-84
PETITIONERS,	33758-84
v.	22524-85
	6400-86
COMMISSIONER OF	21748-86
INTERNAL REVENUE,	25978-86
Respondent.	2786-87

ORDER

On October 12, 1989, petitioners filed motions to vacate the assignment of special trial judge. On January 16, 1990, respondent filed objections to petitioners' motions for the assignment of these cases to a Presidentially appointed Judge of the United States Tax Court and memorandums of points and authorities in support of his objections. On February 15, 1990,

petitioners filed replies to respondent's objections to petitioners' motions to vacate the assignment of special trial judge.

After due consideration of petitioners' above-referenced motions to vacate the assignment of special trial judge, pursuant to I.R.C. section 7482(a)(2) and Rule 193, Tax Court Rules of Practice and Procedure, it is

ORDERED that petitioners' above-referenced motions to vacate the assignment of special trial judge are denied. It is further

ORDERED that these cases are hereby certified for interlocutory appeal to the United States Court of Appeals for the Second Circuit and the United States Court of Appeals for the Ninth Circuit, in that a controlling question of law is involved with respect to which there is a substantial ground for difference of opinion and that an immediate appeal from this order may materially advance the ultimate termination of the litigation in the above-docketed cases. It is further

ORDERED that all proceedings herein are stayed pending resolution of any interlocutory appeal.

/s/ ________________________
Arthur L. Nims, III
Chief Judge

Entered: April 9, 1990

APPENDIX D.

IN THE UNITED STATES COURT OF APPEALS
FOR THE FIFTH CIRCUIT

Nos. 89-4436, 89-4439, 89-4440 and 89-4450

Thomas L. FREYTAG and Sharon N. Freytag, Petitioners-Appellants,
v.
COMMISSIONER OF INTERNAL REVENUE, Respondent-Appellee.

Joe D. WOMBLE and Gladys E. Womble, Petitioners-Appellants,
v.
COMMISSIONER OF INTERNAL REVENUE, Respondent-Appellee.

Bert C. TIMM and Mildred H. Timm, Petitioners-Appellants,
v.
COMMISSIONER OF INTERNAL REVENUE, Respondent-Appellee.

Kenneth G. McCOIN and Candace G. McCoin, Petitioners-Appellants,
v.
COMMISSIONER OF INTERNAL REVENUE, Respondent-Appellee.
Nos. 89-4436, 89-4439, 89-4440 and 89-4450.

Appeal from the Decision of the
United States Tax Court

ON PETITION FOR REHEARING
(August 15, 1990)

Before GEE, POLITZ and JONES, Circuit Judges.

PER CURIAM:

IT IS ORDERED that the petition for rehearing filed in the above entitled and numbered cause be and the same is hereby denied.

ENTERED FOR THE COURT:

/s/ ____________________
Henry A. Politz
United States Circuit Judge

APPENDIX E.

Article I, § 8 of the Constitution of the United States provides:

> The Congress shall have Power . . . To constitute Tribunals inferior to the supreme Court . . . .

Article II, § 2 provides:

> The President . . . shall nominate, and by and with the Advice and Consent of the Senate, shall appoint Ambassadors, other public Ministers and Consuls, Judges of the supreme Court, and all other Officers of the United States, whose Appointments are not herein otherwise provided for, and which shall be established by Law: but the Congress may by Law vest the Appointment of such inferior Officers, as they think proper, in the President alone, in the Courts of Law, or in the Heads of Departments.

Article III, § 1 provides:

> The judicial Power of the United States, shall be vested in one supreme Court, and in such inferior Courts as the Congress may from time to time ordain and establish. The Judges, both of the supreme and inferior Courts, shall hold their Offices during good Behaviour . . . .

Article III, § 2 provides:

> The judicial Power shall extend to all Cases, in Law and Equity, arising under this Constitution, the Laws of the United States, and Treaties made, or which shall be made, under their Authority . . . .

APPENDIX F.

26 U.S.C. § 7443A. Special trial judges

(a) Appointment. — The chief judge may, from time to time, appoint special trial judges who shall proceed under such rules and regulations as may be promulgated by the Tax Court.

(b) Proceedings which may be assigned to special trial judges. — The chief judge may assign —

(1) any declaratory judgment proceeding,

(2) any proceeding under section 7463,

(3) any proceeding where neither the amount of the deficiency placed in dispute (withing the meaning of section 7463) nor the amount of any claimed overpayment exceeds $10,000, and

(4) any other proceeding which the chief judge may designate,

to be heard by the special trial judges of the court.

(c) Authority to make court decision. — The court may authorize a special trial judge to make the decision of the court with respect to any proceeding described in paragraph (1), (2), or (3) of subsection (b), subject to such conditions and review as the court may provide.

(d) Salary. — Each special trial judge shall receive salary —

(1) at a rate equal to 90 percent of the rate for judges of the Tax Court, and

(2) in the same installments as such judges.

(e) Expenses for travel and subsistence. — Subsection (d) of section 7443 shall apply to special trial judges subject to such rules and regulations as may be promulgated by the Tax Court.

(Added Pub.L. 99-514, Title XV, § 1556(a), Oct. 22, 1986, 100 Stat. 2754.)

APPENDIX G.

U.S. Department of Justice

Tax Division

Office of the Assistant Attorney General — Washington, D.C. 20530

April 25, 1990

<u>Airborne Express</u>

Gilbert F. Ganucheau, Esquire
Clerk, U.S. Court of Appeals
for the Fifth Circuit
Room 102, U.S. Court of Appeals
Courthouse
600 Camp Street
New Orleans, Louisiana 70130

Re: Thomas L. Freytag, et al. v. Commissioner (5th Cir. — No. 89-4436) Joe D. Womble, et al. v. Commissioner (5th Cir. — No. 89-4439) Bert C. Timm, et al. v. Commissioner (5th Cir. — No. 89-4440) Kenneth G. McCoin, et al. v. Commissioner (5th Cir. — No. 89-4450)

Dear Mr. Ganucheau:

The above-entitled consolidated cases are scheduled for oral argument on April 30, 1990. One of the issues in the cases concerns the constitutionality of the appointments of Special Trial Judges of the United States Tax Court under the Appointment Clause of the Constitution.

Pursuant to Fed. R. App. P. 28(j), we would like to call to the Court's attention the Statement of the President on Signing the Omnibus Budget Reconciliation Act of 1989, 25 Weekly

Comp. of Pres. Docs. 1970-1 (Dec. 19, 1989) (copy enclosed). This Statement came to the attention of the Tax Division after the filing of its brief in this case.

The arguments presented at pages 46-52 of our brief may be in tension with this Statement. Those arguments are currently being reviewed within the Department of Justice to determine whether they reflect its views.

Four copies of the Presidential Statement are enclosed for the Court's convenience. We are also forwarding a copy of this letter, together with a copy of the Statement, to counsel for the appellants.

Sincerely

/s/ ______________________________

Shirley D. Peterson
Assistant Attorney General
Tax Division

Statement on Signing the Omnibus Budget Reconciliation Act of 1989

* * * * *

I must note, however, that several provisions of this reconciliation bill raise constitutional concerns.

* * * * *

Provisions of the bill appending the National Vaccine Injury Compensation Program also raise concerns. These provisions would provide for initial adjudications of vaccine injury claims by a group of special masters appointed and removable by the United States Claims Court. Although I understand and strongly sympathize with the desire of the Congress to ensure speedy and equitable settlement of meritorious claims, such dispute resolution must take place within the structure of responsible Government established by our Constitution.

The bill's imposition of an "arbitrary and capricious" standard for review of special master decisions by Claims Court judges could raise constitutional questions by vesting significant authority pursuant to the laws of the United States in persons whose appointment and removal are inconsistent with the requirements of Article II of the Constitution, and by circumscribing the ability of Article I and Article III judges to review the decisions of these persons. Accordingly, to place this issue beyond doubt, the Attorney General and the Secretary of HHS will work together to submit legislation that would ensure *de novo* review of decisions rendered by the special masters.

George Bush

The White House,
December 19, 1989.

Note: H.R. 3299, approved December 19, was assigned Public Law No. 101-239.

APPENDIX H.

United States Department of Justice.

Tax Division

John M. Greacen, Esquire
Clerk, U. S. Court of Appeals
for the Fourth Circuit
Room 402, U. S. Courthouse
10th and Main Streets
Richmond, Virginia 23219

August 28, 1990

Re: Littleton G. Lewis, Jr. and Irene Lewis v. Commissioner (4th Cir. – No. 89-2720)

Dear Mr. Greacen:

As you know, the above-entitled case is currently being held in abeyance pending final action on a settlement reached by the parties herein. Before the appeal was held in abeyance, the Government had filed a response to a motion filed by appellant concerning the constitutionality of the appointments of the special trial judges of the Tax Court. Although the Government adheres to the position set forth therein that the appointments of special trial judges comport with the requirements of the Constitution, it had, upon further consideration, concluded that, contrary to the position set forth in that response, the Tax Court is not a "Court[ ] of Law" within the meaning of the Appointments Clause, but that the chief judge of the Tax Court may nevertheless appoint subordinate officers of that court as the "Head[ ] of [a] Department[ ]" under that Clause. This position has now been set forth in the Government's brief filed on August 27, 1990, in a related case presenting this same issue, *Samuels Kramer & Co. v. Commissioner*,

(2d Cir. – Nos. 90-4060, 90-4064). Since the parties here have reached a settlement of the appeal, and are currently awaiting recomputations in accordance with the settlement, there appears to be no reason for the Government to file a supplemental response at this time. We do, however, with to note for the record that the Government's response of January 4, 1990, is not fully in accord with the view of the Government on the question presented. If, for any reason, further proceedings would become necessary herein, we would, of course, request permission to file a supplemental response in accord with the position taken on brief in the *Samuels Kramer & Co.* case.

This case is currently assigned to Steven W. Parks, who may be reached at (202) 514-2958 or FTS 368-2958.

Sincerely yours,

SHIRLEY D. PETERSON
Assistant Attorney General
Tax Division

By:

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